UniCredit

Economics Research

The UniCredit Economics Chartbook

Monthly

Economics, FI/FX & Commodities Research
Credit Research
Equity Research
Cross Asset Research

15 October 2013

10 2013

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Contents

Editorial deadline: 15 October 2013, 9:00 (CET)

Monthly recap

- **EMU:** Our constructive growth outlook remains on track. The last month has been characterized by positive news both on hard and soft data, although this is unlikely to prevent a technical GDP deceleration in 3Q13 as some of the one-off factors that boosted growth in 2Q13 reversed. However, this slowdown will be temporary and in the final quarter we expect growth data to catch up again with improving sentiment indicators. We still think that the ECB will eventually launch another long-term liquidity injection, but the delay in the Fed's tapering of asset purchases eases the pressure for immediate action. An ECB move before 1Q14 now seems unlikely.

- **US:** The government shutdown has delayed several important data releases, so that the assessment of the current situation is based on a very limited set of information. The information that is available indicates that the US economy expanded somewhat slower than we had expected during the summer. We are, therefore, lowering our 3Q13 GDP growth estimate to 2.0% from 2.8%. In addition, we will need to reduce our 4Q13 GDP forecast, from 2.8% currently. Not only will the government shutdown subtract from growth, but the lasting uncertainty over the debt ceiling will weigh on domestic demand, notably business spending. Depending on the length of the shutdown – and assuming that the political parties will be able to avoid a default by agreeing on a short-term extension of the debt limit – we will lower our current-quarter forecast to 1%-2% (if they do not reach an agreement on the debt ceiling, the GDP impact will of course be much bigger). As regards monetary policy, we now expect the Fed will begin to moderate its asset purchases in late January. If the negative implications from the budget battle on the economy and financial markets are too severe, tapering might even be delayed until mid-March.

- **CEE:** Differentiation across CEE continues. Within Central Europe, the recovery in activity is gaining traction, supported by stronger external demand, favorable monetary conditions, and a shift in fiscal stance. In contrast, we expect growth in Russia to remain lackluster, while there are clear signs of a slowdown in Turkey. The need for an external anchor in Ukraine and Serbia is becoming more urgent.

- **China:** The policy shift in late July together with a firming global economy should, most likely, have led to slightly higher 3Q13 GDP growth, compared to the spring quarter (+7.7% yoy versus +7.5% in 2Q13). While it may also lend a helping hand to the Chinese economy over the next few months (prompting us to moderately revise up the quarterly GDP figures), we doubt that the recent policy shift will have a lasting effect, i.e. result in a notable and sustained growth recovery. The medium-term trend still seems to be heading south. We continue to expect that GDP growth rates will head toward 7% late next year rather than approach the 8% mark.

Table 1: Annual macroeconomics forecasts

	GDP (%)			CPI inflation (%)			Central Bank Rate (EoP)			Government budget balance (% GDP)			Government gross debt (% GDP)			Current account balance (% GDP)		
	2012	2013	2014	2012	2013	2014	2012	2013	2014	2012	2013	2014	2012	2013	2014	2012	2013	2014
Eurozone	-0.6	-0.3	1.0	2.5	1.5	1.5	0.75	0.50	0.50	-3.7	-3.0	-2.7	90.6	92.9	92.5	1.2	1.9	2.3
Germany	0.9	0.6	1.5	2.0	1.5	1.4	-	-	-	0.2	0.0	-0.2	81.7	79.2	76.9	6.4	5.9	5.5
France	0.0	0.2	0.9	2.0	1.0	1.9	-	-	-	-4.8	-4.0	-3.5	90.2	92.6	94.7	-2.0	-2.0	-1.7
Italy	-2.4	-1.7	0.6	3.0	1.5	1.8	-	-	-	-3.0	-3.1	-2.3	127.0	133.1	133.3	-0.5	0.4	0.6
Spain	-1.6	-1.4	0.4	2.4	1.9	1.6	-	-	-	-10.6	-6.5	-6.1	85.9	94.0	98.0	-1.1	1.0	2.1
Austria	0.9	0.4	1.8	2.4	1.9	1.8	-	-	-	-2.5	-2.3	-1.7	74.0	74.8	74.4	1.8	2.5	2.7
Greece	-6.5	-4.5	0.2	1.5	-0.5	-0.1	-	-	-	-10.0	-5.0	-4.2	156.9	179.0	175.0	-2.9	-1.2	-0.3
Portugal	-3.2	-2.0	0.3	2.8	0.5	0.7	-	-	-	-6.4	-5.6	-4.0	123.6	127.9	129.0	-1.6	0.3	0.2
Other EU																		
UK	0.2	1.6	3.1	2.8	2.8	2.8	0.50	0.50	0.50	-6.3	-5.9	-4.9	90.0	94.0	96.0	-3.7	-3.2	-2.7
Sweden	1.0	0.8	2.6	0.9	0.1	1.6	1.00	1.00	1.25	-0.7	-1.5	-1.0	38.8	42.5	42.5	6.9	6.4	6.2
Poland	1.9	1.3	2.3	3.7	1.0	2.3	4.25	2.50	2.50	-3.9	-4.9	-3.9	55.6	58.3	52.1	-3.7	-1.6	-2.9
Czech Rep.	-0.9	-0.9	2.0	3.3	1.4	1.0	0.05	0.05	0.05	-4.4	-2.5	-2.9	46.2	47.4	48.6	-2.4	-1.1	-1.0
Hungary	-1.7	0.7	1.7	5.7	1.7	1.7	5.75	3.50	3.50	-1.9	-2.7	-3.0	79.2	81.6	82.3	1.7	1.8	1.4
Others																		
US	2.8	1.6	2.4	2.1	1.6	2.3	0.25	0.25	0.25	-8.3	-5.8	-4.6	102.7	106.0	107.3	-3.1	-3.0	-3.1
Switzerland	1.0	1.8	1.8	-0.7	-0.2	0.7	0.00	0.00	0.50	0.5	0.3	0.3	36.5	35.8	34.7	13.1	12.0	11.0
Russia	3.4	1.7	1.8	5.1	6.7	4.9	5.50	5.25	4.75	-0.1	-0.7	-0.7	10.2	11.7	12.8	4.0	2.1	0.7
Turkey	2.2	3.9	2.0	8.9	7.4	6.7	5.50	4.50	6.00	-1.5	-1.5	-3.5	36.6	36.5	37.1	-9.7	-6.1	-7.1
China	7.8	7.6	7.2	2.7	2.6	3.0	6.00	6.00	6.00	-1.7	-1.8	-1.8	-	-	-	2.3	2.1	2.2

Source: UniCredit Research

Table 2: Quarterly GDP and CPI forecasts

REAL GDP (% QOQ, SA)

	3Q12	4Q12	1Q13	2Q13	3Q13	4Q13	1Q14	2Q14	3Q14	4Q14
Eurozone	-0.1	-0.5	-0.2	0.3	0.1	0.2	0.2	0.3	0.3	0.4
Germany	0.2	-0.5	0.0	0.7	0.5	0.4	0.4	0.3	0.3	0.4
France	0.2	-0.2	-0.2	0.5	0.1	0.2	0.2	0.3	0.3	0.4
Italy	-0.2	-0.9	-0.6	-0.3	0.0	0.1	0.2	0.2	0.3	0.4
Spain	-0.4	-0.8	-0.4	-0.1	-0.1	0.1	0.1	0.2	0.2	0.3
Austria	0.1	-0.1	0.1	0.1	0.4	0.6	0.5	0.4	0.4	0.4
Other EU										
UK	0.6	-0.3	0.4	0.7	0.9	1.0	0.7	0.7	0.6	0.5
Sweden	0.2	-0.2	0.3	-0.2	0.6	0.6	0.7	0.7	0.8	0.8
Poland (% yoy)	1.3	0.7	0.5	0.8	1.6	2.1	2.7	2.3	2.2	2.1
Czech Rep.	-0.3	-0.3	-1.3	0.6	0.6	0.5	0.4	0.5	0.5	0.5
Hungary	0.0	-0.5	0.6	0.1	0.4	0.6	0.5	0.4	0.1	0.3
Others										
US (annualized)	2.8	0.1	1.1	2.5	2.0	2.8	2.6	2.5	2.4	2.4
Switzerland	0.7	0.3	0.6	0.5	0.4	0.5	0.4	0.4	0.4	0.4
Russia	0.5	0.2	0.4	0.3	0.4	0.6	0.5	0.2	0.5	0.7
Turkey	0.1	0.0	1.6	1.8	1.0	-0.3	0.2	0.4	0.7	0.7
China (% yoy)	7.4	7.9	7.7	7.5	7.7	7.5	7.5	7.3	7.2	7.1

CPI INFLATION (% YOY)

	3Q12	4Q12	1Q13	2Q13	3Q13	4Q13	1Q14	2Q14	3Q14	4Q14
Eurozone	2.5	2.3	1.9	1.4	1.4	1.3	1.3	1.6	1.4	1.5
Germany	2.0	2.0	1.5	1.5	1.6	1.2	1.2	1.2	1.4	1.5
France	2.0	1.5	1.1	0.8	1.0	1.2	1.8	2.1	2.0	2.0
Italy	3.2	2.5	1.9	1.2	1.1	1.4	1.4	1.7	1.7	1.5
Spain (HICP)	2.8	3.2	2.8	1.8	1.5	1.7	1.5	2.1	1.4	1.3
Austria	2.3	2.8	2.5	2.2	1.7	1.2	1.4	1.6	2.0	2.1
Other EU										
UK	2.4	2.7	2.8	2.7	2.8	3.1	2.9	2.9	2.8	2.7
Sweden	0.6	0.1	-0.1	-0.3	0.1	0.6	1.0	1.7	1.9	2.1
Poland	3.9	2.9	1.3	0.5	1.1	1.2	2.1	2.4	2.1	2.5
Czech Rep.	3.3	2.8	1.8	1.5	1.2	1.1	0.5	0.9	1.3	1.5
Hungary	6.1	5.3	2.8	1.7	1.2	1.2	0.9	1.1	2.0	2.7
Others										
US	1.7	1.9	1.7	1.4	1.6	1.6	1.8	2.4	2.5	2.6
Switzerland	-0.5	-0.3	-0.4	-0.4	0.0	0.1	0.5	0.8	0.6	0.8
Russia	6.0	6.5	7.2	7.2	6.4	5.9	5.4	5.1	4.5	4.8
Turkey	9.0	5.8	7.2	7.0	8.3	8.1	7.4	8.0	7.3	7.9
China	1.9	2.5	2.4	2.4	2.8	2.8	2.8	2.9	3.1	3.2

Source: UniCredit Research

Table 3: Comparison of annual GDP and CPI forecasts

GDP (%)

	UniCredit			IMF (Oct-13)			European Commission (May-13)			OECD (May-13)		
	2012	2013	2014	2012	2013	2014	2012	2013	2014	2012	2013	2014
Eurozone	-0.6	-0.3	1.0	-0.6	-0.4	1.0	-0.6	-0.4	1.2	-0.5	-0.6	1.1
Germany	0.9	0.6	1.5	0.9	0.5	1.4	0.7	0.4	1.8	0.9	0.4	2.0
France	0.0	0.2	0.9	0.0	0.2	1.0	0.0	-0.1	1.1	0.0	-0.3	0.8
Italy	-2.4	-1.7	0.6	-2.4	-1.8	0.7	-2.4	-1.3	0.7	-2.4	-1.8	0.4
Spain	-1.6	-1.4	0.4	-1.6	-1.3	0.2	-1.4	-1.5	0.9	-1.4	-1.7	0.4
Austria	0.9	0.4	1.8	0.9	0.4	1.6	0.8	0.6	1.8	0.8	0.5	1.7
Greece	-6.5	-4.5	0.2	-6.4	-4.2	0.6	-6.4	-4.2	0.6	-6.4	-4.8	-1.3
Portugal	-3.2	-2.0	0.3	-3.2	-1.8	0.8	-3.2	-2.3	0.6	-3.2	-2.7	0.2
Other EU												
UK	0.2	1.6	3.1	0.2	1.4	1.9	0.3	0.6	1.7	0.3	0.8	1.5
Sweden	1.0	0.8	2.6	1.0	0.9	2.3	0.8	1.5	2.5	1.2	1.3	2.5
Poland	1.9	1.3	2.3	1.9	1.3	2.4	1.9	1.1	2.2	2.0	0.9	2.2
Czech Rep.	-0.9	-0.9	2.0	-1.2	-0.4	1.5	-1.3	-0.4	1.6	-1.2	-1.0	1.3
Hungary	-1.7	0.7	1.7	-1.7	0.2	1.3	-1.7	0.2	1.4	-1.8	0.5	1.3
Others												
US	2.8	1.6	2.4	2.8	1.6	2.6	2.2	1.9	2.6	2.2	1.9	2.8
Switzerland	1.0	1.8	1.8	1.0	1.7	1.8	1.0	1.4	1.9	1.0	1.4	2.0
Russia	3.4	1.7	1.8	3.4	1.5	3.0	3.4	3.3	3.8	3.4	2.3	3.6
Turkey	2.2	3.9	2.0	2.2	3.8	3.5	2.2	3.2	4.0	2.2	3.1	4.6
China	7.8	7.6	7.2	7.7	7.6	7.3	7.8	8.0	8.1	7.8	7.8	8.4

CPI INFLATION (%)*

	UniCredit			IMF (Oct-13)			European Commission (May-13)			OECD (May-13)		
	2012	2013	2014	2012	2013	2014	2012	2013	2014	2012	2013	2014
Eurozone	2.5	1.5	1.5	2.5	1.5	1.5	2.5	1.6	1.5	2.5	1.5	1.2
Germany	2.0	1.5	1.4	2.1	1.6	1.8	2.1	1.8	1.6	2.1	1.6	2.0
France	2.0	1.0	1.9	2.2	1.0	1.5	2.2	1.2	1.7	2.2	1.1	1.0
Italy	3.0	1.5	1.8	3.3	1.6	1.3	3.3	1.6	1.5	3.3	1.6	1.2
Spain	2.4	1.9	1.6	2.4	1.8	1.5	2.4	1.5	0.8	2.4	1.5	0.4
Austria	2.4	1.9	1.8	2.6	2.2	1.8	2.6	2.0	1.8	2.6	2.0	1.5
Greece	1.5	-0.5	-0.1	1.5	-0.8	-0.4	1.0	-0.8	-0.4	1.0	-0.7	-1.7
Portugal	2.8	0.5	0.7	2.8	0.7	1.0	2.8	0.7	1.0	2.8	0.0	0.2
Other EU												
UK	2.8	2.8	2.8	2.8	2.7	2.3	2.8	2.8	2.5	2.8	2.8	2.4
Sweden	0.9	0.1	1.6	0.9	0.2	1.6	0.9	0.9	1.4	0.9	0.3	1.3
Poland	3.7	1.0	2.3	3.7	1.4	1.9	3.7	1.4	2.0	3.6	0.7	1.0
Czech Rep.	3.3	1.4	1.0	3.3	1.8	1.8	3.5	1.9	1.2	3.3	1.6	1.3
Hungary	5.7	1.7	1.7	5.7	2.3	3.0	5.7	2.6	3.1	5.7	2.8	3.5
Others												
US	2.1	1.6	2.3	2.1	1.4	1.5	2.1	1.8	2.1	2.1	1.6	1.9
Switzerland	-0.7	-0.2	0.7	-0.7	-0.2	0.2	-0.7	0.0	1.1	-0.7	-0.3	0.2
Russia	5.1	6.7	4.9	5.1	6.7	5.7	-	-	-	5.1	6.6	5.4
Turkey	8.9	7.4	6.7	8.9	6.6	5.3	9.0	6.6	5.6	8.9	6.7	5.2
China	2.7	2.6	3.0	2.6	2.7	3.0	-	-	-	2.6	2.5	2.6

*UniCredit forecasts refer to CPI with the exception of Spain, where HICP is used. IMF and OECD inflation forecasts refer to the CPI except for eurozone countries, where HICP is used. EC inflation forecasts refer to the HICP, except for the US and Russia, where CPI is used. Please note that in the UK, CPI and HICP coincide.

Source: IMF, European Commission, OECD, UniCredit Research

Table 4: Global G10 FI/FX forecasts

EU	Current	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14
Key rate	0.50	0.50	0.50	0.50	0.50	0.50
3M	0.23	0.25	0.25	0.35	0.40	0.45
2Y	0.18	0.30	0.45	0.55	0.85	1.20
5Y	0.84	1.00	1.20	1.40	1.68	1.95
10Y	1.86	2.00	2.20	2.40	2.60	2.80
30Y	2.74	2.75	2.95	3.10	3.25	3.40
2/10	169	170	175	185	175	160
2/5/10	-18	-15	-13	-8	-5	-5
10/30	87	75	75	70	65	60
2Y SwSp	-40	-35	-30	-30	-25	-25
10Y SwSp	-30	-30	-25	-25	-20	-20
10Y BTP/bund	239	250	230	210	200	190
US						
Key rate	0.25	0.25	0.25	0.25	0.25	0.25
3M	0.24	0.26	0.30	0.30	0.35	0.35
2Y	0.35	0.45	0.60	0.70	1.00	1.35
5Y	1.42	1.75	2.02	2.20	2.47	2.73
10Y	2.69	3.00	3.20	3.40	3.60	3.80
30Y	3.75	3.90	4.05	4.20	4.30	4.40
2/10	234	255	260	270	260	245
2/5/10	-10	2	12	15	17	15
10/30	106	90	85	80	70	60
2Y SwSp	-13	-15	-15	-15	-15	-15
10Y SwSp	-13	-20	-20	-20	-20	-20
UK						
Key rate	0.50	0.50	0.50	0.50	0.50	0.50
10Y	2.74	3.00	3.20	3.30	3.50	3.70
SZ						
Key rate	0.00	0.00	0.00	0.00	0.00	0.00
10Y	1.04	1.25	1.40	1.60	1.80	2.00

FX	Current	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14
EUR-USD	1.36	1.35	1.35	1.36	1.37	1.38
EUR-JPY	133	144	149	152	156	157
EUR-GBP	0.85	0.86	0.86	0.87	0.88	0.88
EUR-SEK	8.78	8.60	8.58	8.55	8.53	8.50
EUR-NOK	8.12	7.80	7.70	7.60	7.55	7.55
EUR-CHF	1.23	1.30	1.35	1.36	1.37	1.38
EUR-AUD	1.43	1.42	1.39	1.37	1.37	1.35
EUR-NZD	1.62	1.69	1.67	1.68	1.67	1.68
EUR-CAD	1.40	1.36	1.36	1.36	1.34	1.34
USD-JPY	98	107	110	112	114	114
GBP-USD	1.60	1.57	1.57	1.57	1.56	1.56
USD-SEK	6.48	6.37	6.36	6.29	6.23	6.16
USD-NOK	5.99	5.78	5.70	5.59	5.51	5.47
USD-CHF	0.91	0.96	1.00	1.00	1.00	1.00
AUD-USD	0.95	0.95	0.97	0.99	1.00	1.02
NZD-USD	0.84	0.80	0.81	0.81	0.82	0.82
USD-CAD	1.03	1.01	1.01	1.00	0.98	0.97

Source: Bloomberg, UniCredit Research

Eurozone

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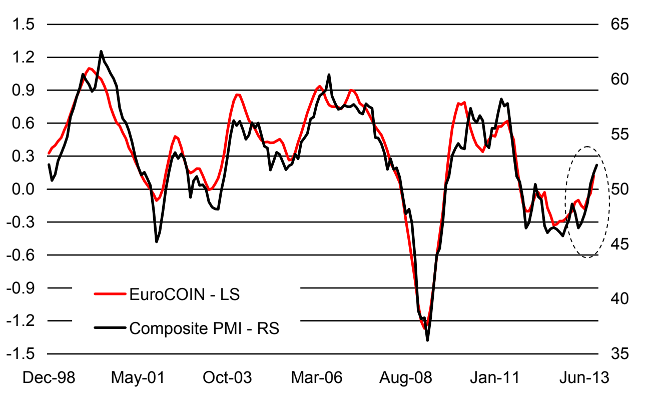
- Our constructive growth outlook remains on track. The last month has been characterized by positive news both on hard and soft data, although this is unlikely to prevent a technical (and temporary) GDP deceleration in 3Q13 as some of the one-off factors that boosted growth in 2Q13 reversed. IP staged a good rebound in August (+1.0%), offsetting the July drop and confirming that the trend in activity remains up. At the same time, business surveys have continued to drift higher, with the Composite PMI (up to 52.2 in September from 51.5) reaching its highest level since mid-2011, consistent with 0.3% qoq GDP growth.

- This first leg of the eurozone recovery has been driven by an acceleration of the export impulse and increasing signs of stabilization in domestic demand. We have been closely monitoring the improvement in corporate fundamentals, especially profitability, which seems to have finally turned. With capacity utilization back on the rise, a moderate investment recovery seems in the offing, especially given the current very depressed level of capex. Helped by slowing fiscal consolidation and low inflation, household confidence has been recovering for the last ten months, approaching its long-term average. This indicates that the consumption recession is most likely over. The labor market remains under pressure, but this is hardly surprising given that employment usually lags behind the business cycle, while firms have just started to restore their margins.

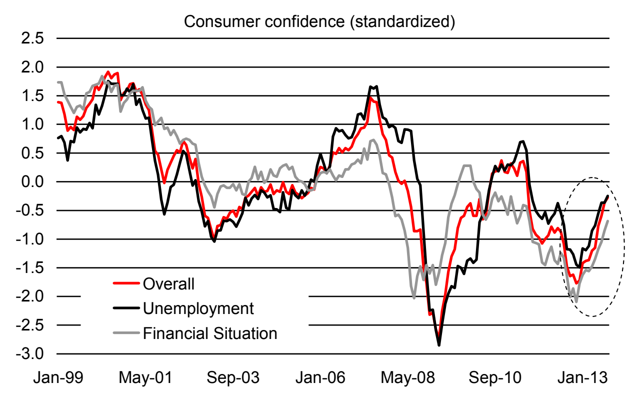
- Lending to the private sector remains weak (-2.0% yoy), mainly because the contraction of loans to NFCs is still accelerating. We are not concerned by this trend. In previous cycles, lending always lagged behind real economic activity by about two or three quarters. As our forecast for a gradual GDP recovery remains on track, we continue to expect the lending cycle to start turning towards the end of the year.

- The ECB's baseline scenario for GDP and CPI has been confirmed by the latest information and, for now, the central bank can wait and see. We still think that the ECB will need to do more to support the financial sector and the real economy and that this accommodation will come through another long-term liquidity injection rather than a rate cut. However, the timing and the method of this renewed move remain highly uncertain. For sure, the delay of the Fed's tapering has eased pressure on the ECB to act, and several ECB members have described current liquidity conditions as appropriate. Therefore, the ECB seems unlikely to make a move before 1Q14. With respect to the features of the new refinancing operation, we know that the central bank does not want liquidity to delay the needed restructuring of the banking sector. This seems to indicate that the ECB is looking at a new version of LTRO, which is possibly similar to the BoE's Funding for Lending Scheme (FLS).

SOFT INDICATORS ON A RISING TREND (I)



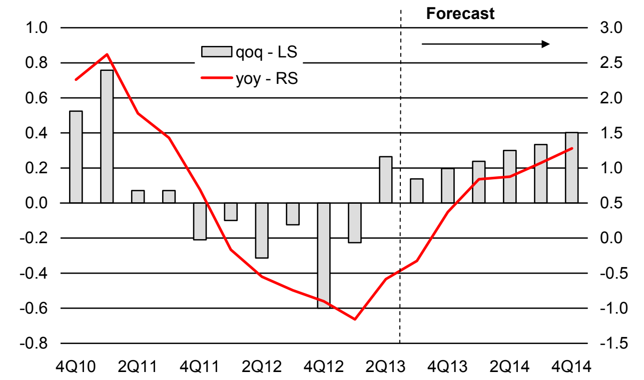
SOFT INDICATORS ON A RISING TREND (II)



Source: BoI, EC, Markit, UniCredit Research

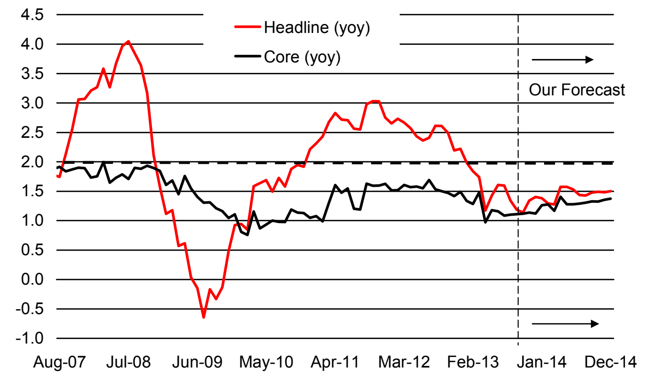
Eurozone

GDP



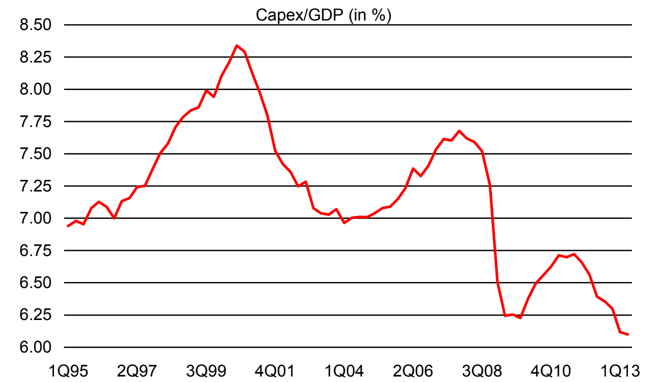
- We expect a temporary GDP deceleration in 3Q.

INFLATION



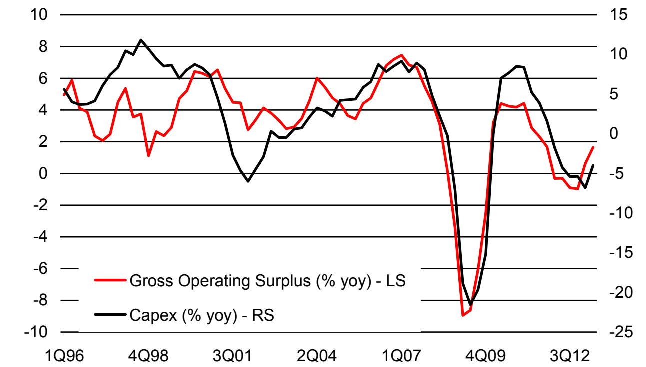
- Inflation remains muted.

CAPEX



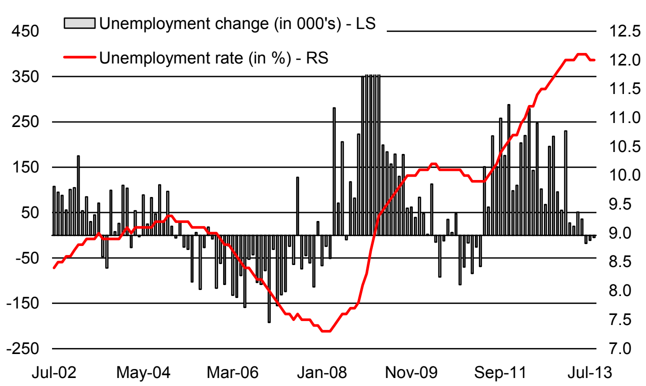
- Capex-to-GDP ratio at an all-time low

PROFITABILITY



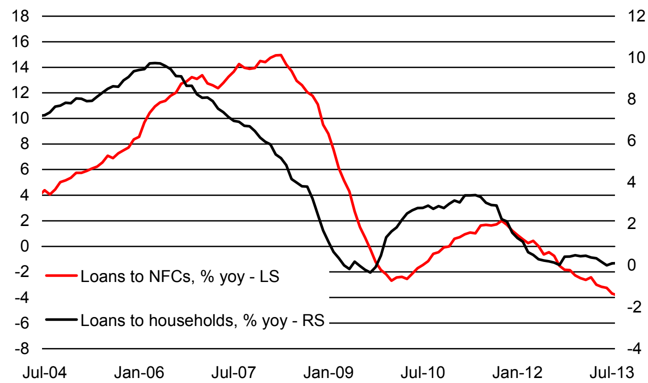
- Firms' profitability has started to recover.

LABOR MARKET



- Unemployment rate stabilizes.

LENDING



- Downward trend in corporate lending persists.

Source: Bloomberg, EC, ECB, Eurostat, UniCredit Research

Germany

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- Recent surveys among companies confirm that the upward trend in the German economy is intact. While the Manufacturing PMI decreased moderately in September after three consecutive increases, the Ifo business expectations component continued to rise (see left chart). We think that one of the major reasons is the recent synchronous improvement in business surveys in France, Italy and Spain. After all, the eurozone is still by far the most important export market for German companies with an export share of 37%.

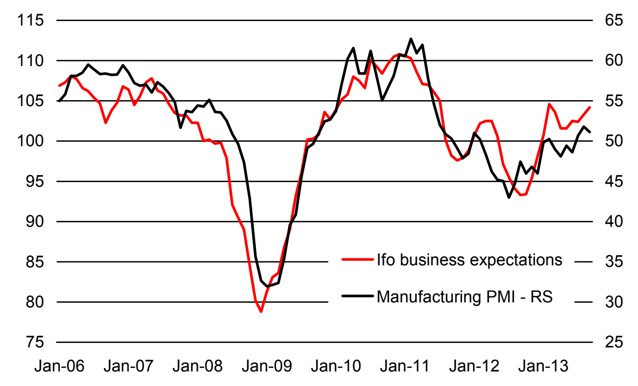
- Hard data for August largely came in on a positive note. For instance, industrial production rose 1.4% mom, primarily driven by strong activity in the auto sector. Exports were up 1.0% mom. Retail sales increased 0.5%. The only exception was new orders declining moderately, as a large swing in big-ticket items dragged down the headline figure. However, looking at the numbers for July and August together, some downside risks to our growth forecast of 0.6% qoq have emerged (due to rather disappointing July readings). Our GDP tracker currently signals plus 0.3-0.4% qoq on the basis of the hard data available so far.

- The number of jobs increased further. This is especially true for employment liable to social security contributions, i.e. excluding "minor employment". Since the start of this year, nearly 20,000 new jobs per month have been created so far (excluding minor employment: 33,000). The ongoing recovery on the labor market bodes well for private consumer spending. The consumer climate index (GfK) recently hit its highest level in the last six years (see right chart below).

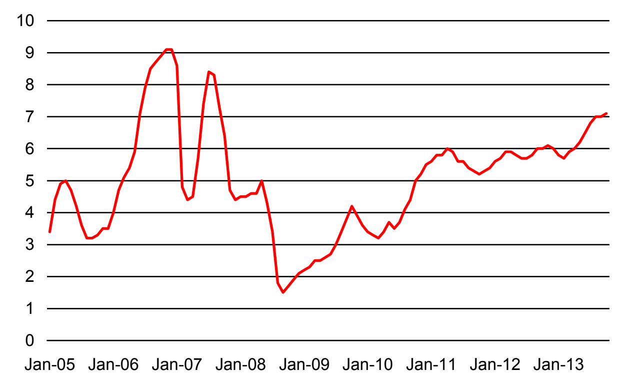
- After the moderate increase in investment in machinery and equipment in 2Q13, we stick to our view that further rises are in the pipeline. Until spring this year, investment activity of German companies had been a sustained weak spot. Besides a recovery in exports and robust consumer spending, the expected "unloading" of pent-up demand in investment activity in the next few quarters remains an essential part of our medium-term growth story.

- After the German federal election in September, first exploratory talks between parties have started. We continue to expect a grand coalition between the CDU/CSU and the SPD. While both parties widely agree on European policy, domestic issues such as tax policy, minimum wages and energy policy are more controversial. Ending the negotiations in mid-November already, as suggested by some Social Democrats, seems (too) ambitious.

UPWARD TREND IN BUSINESS SURVEYS INTACT



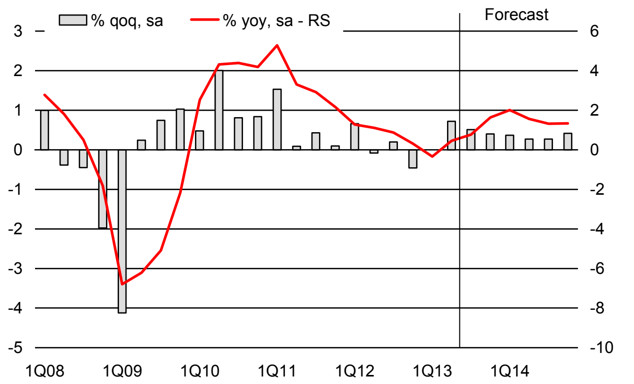
CONSUMERS ARE BECOMING MORE OPTIMISTIC (GFK)



Source: Feri, Ifo, Markit, UniCredit Research

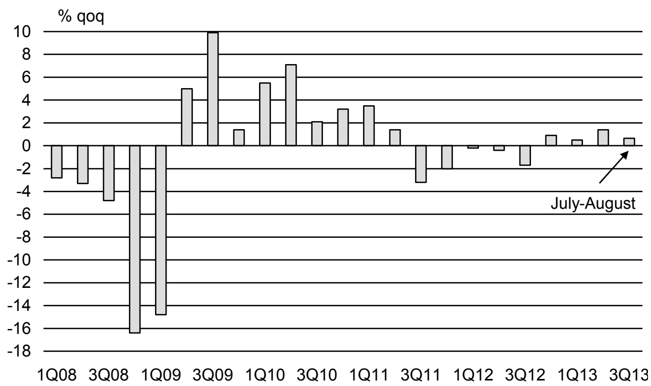
Germany

GDP



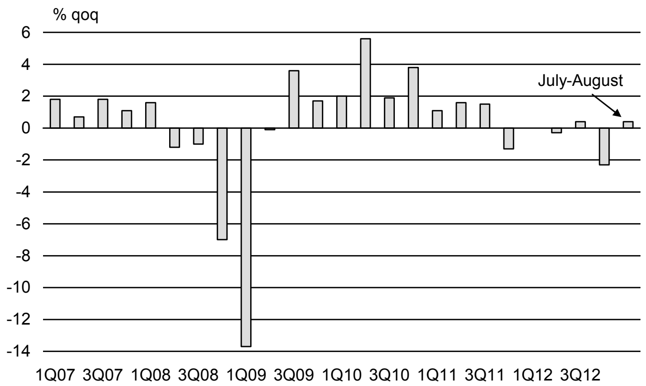
- After the strong weather-related rebound of 0.7% qoq in 2Q13, we expect somewhat less dynamic growth in 2H13.

NEW ORDERS



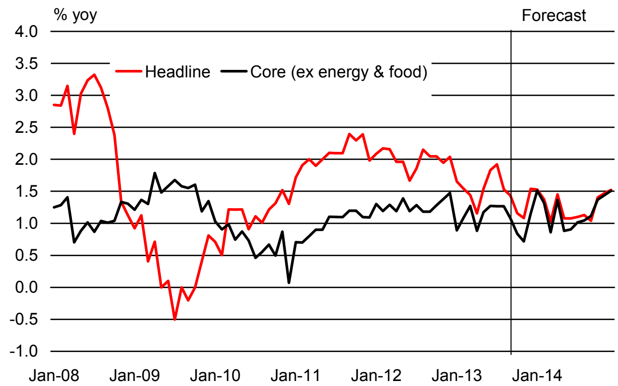
- New orders in August decreased slightly due to big-ticket items (July-August: +0.7% compared to 2Q13).

MANUFACTURING PRODUCTION



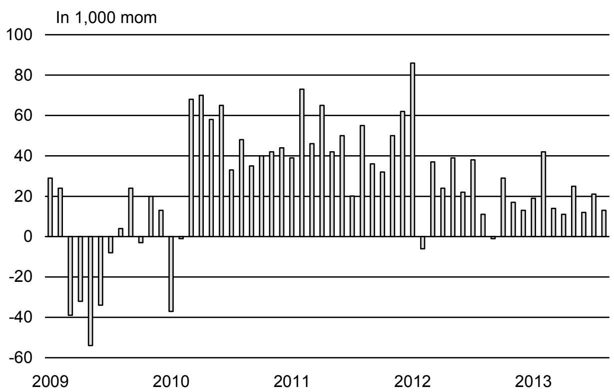
- Manufacturing output rose strongly in August, largely driven by the auto sector, after a big drop in the previous month.

INFLATION



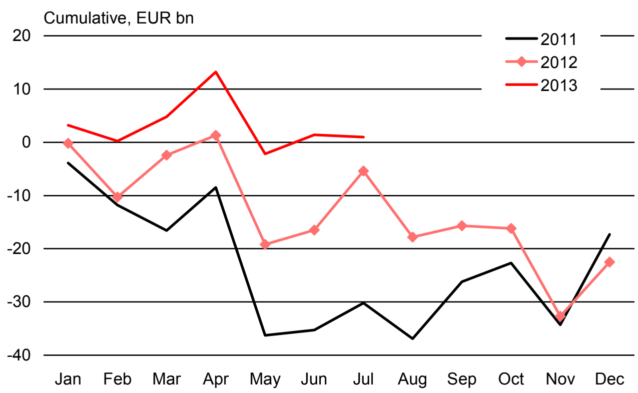
- Consumer price inflation eased further to 1.4% yoy in September.

EMPLOYMENT



- Employment has continued to rise in recent months. On average, job gains were nearly 20,000 per month so far this year (2012: +26,000).

FEDERAL BUDGET BALANCE



- Thanks to increasing tax revenues, the federal budget balance has been slightly positive.

Source: Bundesbank, FSO, Ministry of Finance, UniCredit Research

France

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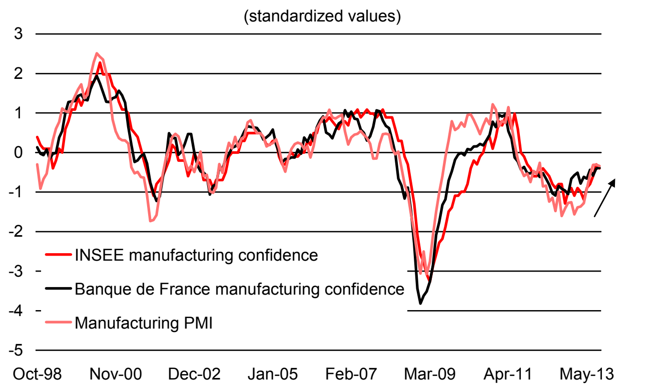
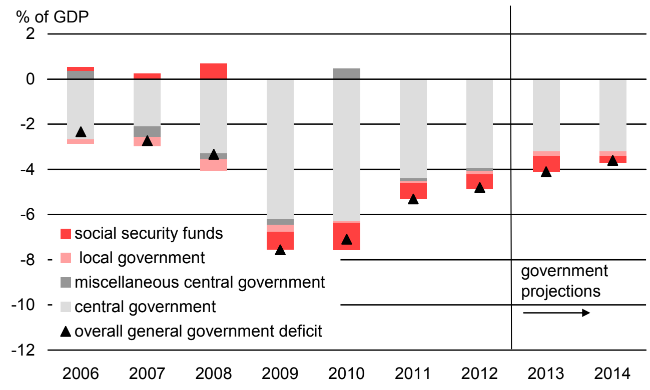
- Latest hard data up to August have come in on the soft side. Industrial production was disappointing in August (+0.2% mom vs. -0.6% mom in July), hinting at a significant correction of the gains recorded in the second quarter (when IP surged 1.3% qoq). Household spending figures were also weak (+0.4% mom vs. -0.4%), suggesting that private consumption would at best stagnate in the quarter, following a fairly solid acceleration in 2Q (+0.4% qoq). On a positive note, construction data have so far shown a fair degree of resilience after a strong 2Q (+3.3% qoq), indicating that the sector will continue to contribute to GDP growth in 3Q, albeit to a lesser extent than in 2Q. However, we are not particularly concerned about this string of weak data. The GDP slowdown that we envisage is mainly driven by the unwinding of temporary factors that played a large role in boosting 2Q GDP (i.e. unusually high energy consumption), while the underlying trend of recovery in activity remains intact. Actually, GDP momentum is likely to regain traction already in 4Q, in line with indications from clearly improving sentiment indicators.
- On 30 September, the French government unveiled its draft budget for 2014, which targets a reduction in the nominal deficit from 4.1% of GDP in 2013 to 3.6% in 2014. This forecast relies on the assumption that real GDP growth will accelerate from +0.1% to +0.9% in 2014 (same as our forecast). The 3.6% target confirms the commitment to fiscal retrenchment agreed on with the European Commission last spring, when Brussels conceded a two-year extension to bring the nominal deficit below 3%. In regard to the structural deficit (i.e. adjusted for the cycle and net of one-offs), the government targets an improvement of 0.9pp in 2014 after 1.5pp in 2013, also broadly in line with Brussels' recommendations. The change in the structural balance, which measures the fiscal effort, is worth EUR 18bn in 2014, coming mainly from spending cuts (EUR 15bn) rather than higher taxation (EUR 3bn). This is in an apparent departure from past trends and consistent with the government's recent commitment to make budgetary consolidation more growth-friendly. However, we acknowledge that the recent government decision to cancel a new 1% tax on gross operating profits exceeding EUR 50mn and replace it with a temporary (and generalized) corporate tax increase risks weakening this commitment.
- The bulk of the EUR 15bn expenditure reduction effort will weigh on central and local governments, but also the contribution from social security will be significant, at EUR 6bn. Specifically, current expenditure rules on central government and healthcare will be tightened and this will contribute to generate higher savings. The recent postponement from 1 April to 1 October of the date on which pensions are revalued once a year in line with prices will also contribute to spending restraint. As a result of these measures, public spending will decline from 57.1% of GDP in 2013 to 56.7% in 2014.

THE RECOVERY TREND IN MANUFACTURING REMAINS INTACT



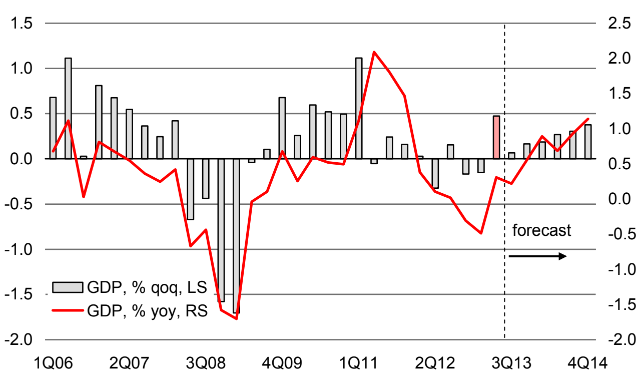
SOCIAL SECURITY WILL PLAY A BIG ROLE IN CONSOLIDATION



Source: INSEE, Markit, UniCredit Research

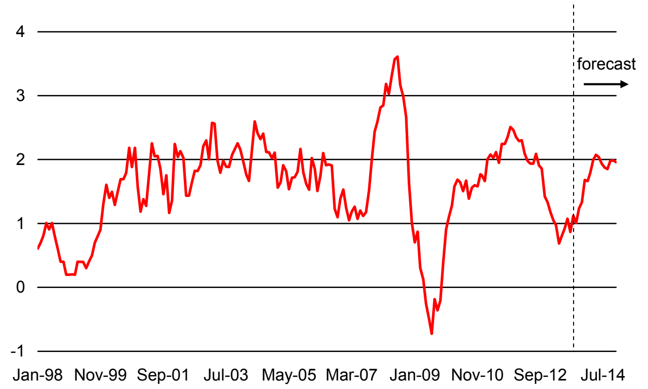
France

GDP



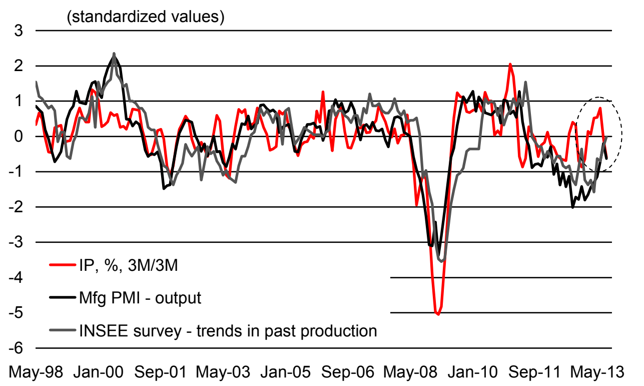
■ We expect GDP forecast to grow 0.2% in 2013, and 0.9% in 2014.

INFLATION



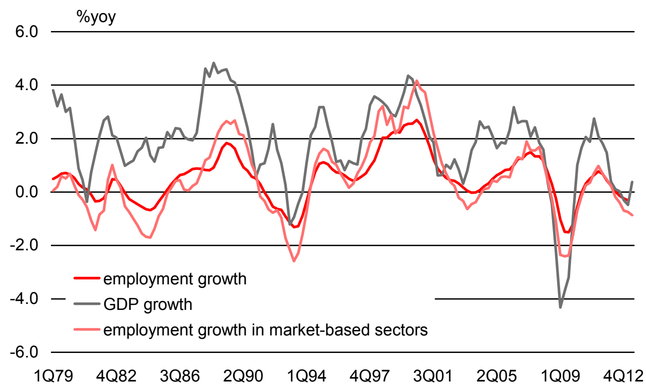
■ CPI edged down 0.2pp to 0.9% in August. We currently estimate inflation averaging 1.0% in 2013 and 1.9% in 2014.

INDUSTRIAL PRODUCTION



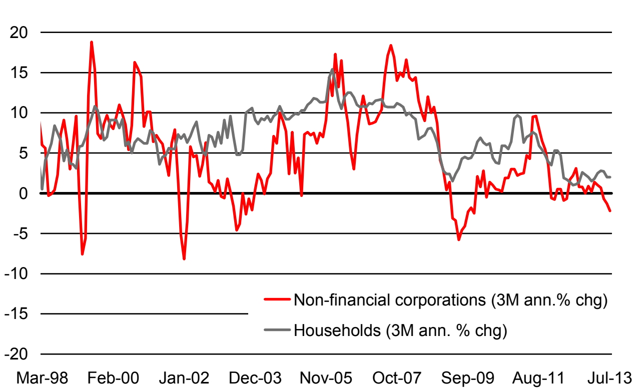
■ Latest IP data have closed the gap with manufacturing surveys.

EMPLOYMENT



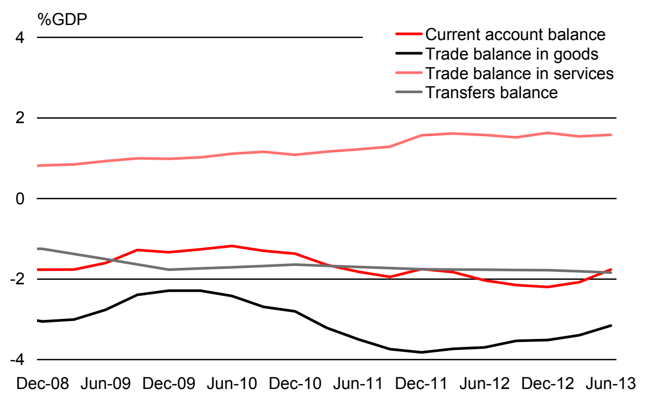
■ The pace of job destruction slightly accelerated in the market-based sectors in 2Q13.

LENDING TO THE PRIVATE SECTOR



■ Lending growth to NFCs started to contract again from May.

CURRENT ACCOUNT



■ The current account deficit stabilized at 1.8% of GDP by the end of 2Q13, the lowest reading since March 2012.

Source: INSEE, Markit, Banque de France, UniCredit Research

Italy

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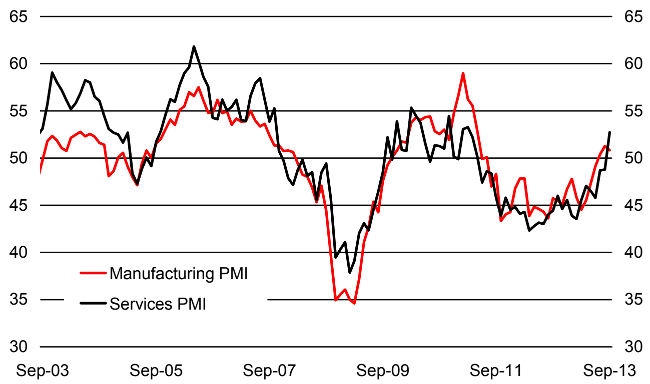
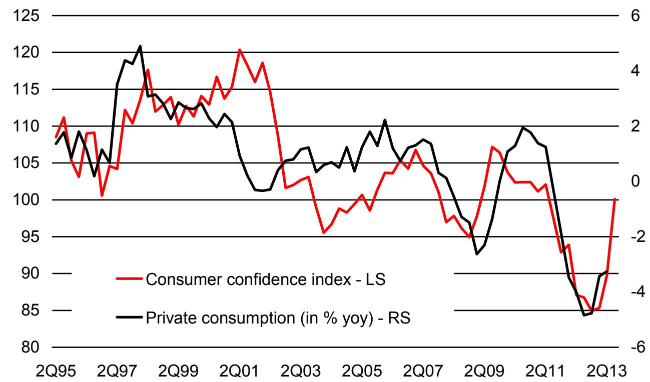
- Both the manufacturing and service PMI indicators showed a solid improvement in 3Q13, clearly supporting our view of a more positive picture in this quarter. On an equally positive note, consumer sentiment jumped more than expected to 101.1, the highest reading since June 2011. While the sharp improvement over last few months is partly due to a methodological change introduced in June (which explains about 3pp of the increase in the overall index), the underlying trend in consumer sentiment is clearly heading north. This bodes well for our expectation of an easing of the consumer recession in 3Q13, followed by a stabilization/gradual recovery thereafter.
- Disappointing expectations for a rebound, industrial production declined further in August (-0.3% mom, after -1.0% in July). However, the fall in monthly IP was entirely driven by the energy component. We expect IP to stage a solid recovery at the end of 3Q13, but the IP performance in the quarter is likely to be slightly weaker than previously expected. Given the other data already available – including a solid improvement in the services PMI, but also a renewed contraction in car registrations – our forecast for flat GDP in 3Q13 remains on track, although we now see some downside risks.
- In September, the state sector borrowing requirement (SSBR) was EUR 15.5bn vs. EUR 11.4bn in 2012 and the Treasury reported that the cash deficit was negatively affected by further payments of PA arrears (EUR 2.4bn, totaling about EUR 6bn YTD) and higher interest payments (EUR 1.5bn), due to a different supply schedule than in 2012. YTD, the SSBR shows a visible deterioration compared to the previous year (see left chart on the next page), but this is mostly due to: 1. a technical change that occurred in the management of the state sector Treasury (*Tesoreria*), which explains about EUR 9.5bn of the EUR 17.1bn gap in total expenditure up to July (see right table); and 2. a worsening in the financial accounts balance, due to some one-off factors that won't affect the fiscal deficit (Maastricht criteria), estimated on an accrual basis. In September's Documento di Economia e Finanza, the government set a 2013 cash deficit target of 3.6% of GDP (up from the previous 3.4%), which, however, don't include payments of PA arrears worth 1.7% of GDP.
- On 2 October, PM Enrico Letta survived a confidence vote with a very comfortable majority in the Senate (235 votes in favor and 70 against, with the absolute majority requiring 161 seats). In our view, the swift solution to the political impasse that emerged at the end of September increases the probability that Letta's government will survive until at least the end of 2014, allowing Italy to take over the EU presidency in 2H14 in a comfortable domestic political environment. The potential for this cabinet to pass reforms (both economic and institutional) appears also to have increased, although this will mostly depend on whether political tensions within the moderate and extremist wings of the People of Freedom party will lead to a clear prevalence of the moderate camp.

SHARP IMPROVEMENT IN BUSINESS AND…



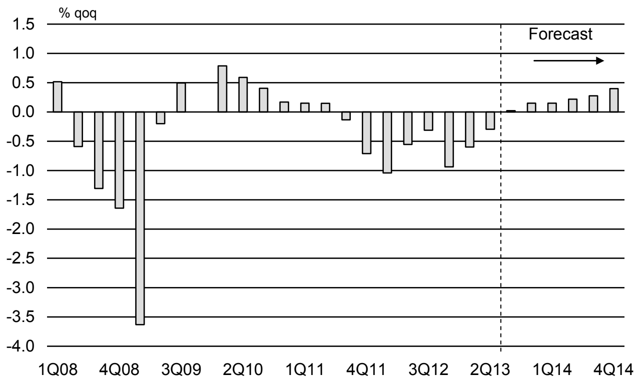
…CONSUMER CONFIDENCE



Source: Markit, ISTAT, UniCredit Research

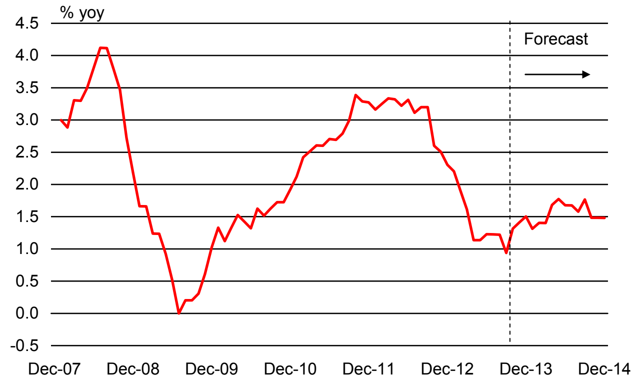
Italy

GDP



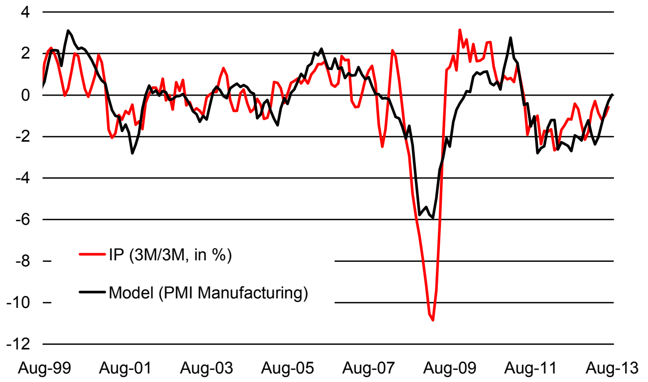
- GDP is expected to be flat in 3Q13 and show marginally positive growth at year-end.

INFLATION



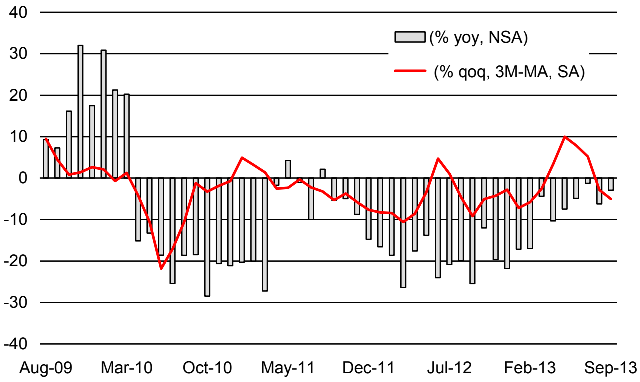
- Inflation slowed further to 0.9% in September. October's forecast includes a 1pp VAT hike (from 21% to 22%), which is expected to raise consumer prices by 0.3-0.4pp on a monthly basis.

INDUSTRIAL PRODUCTION



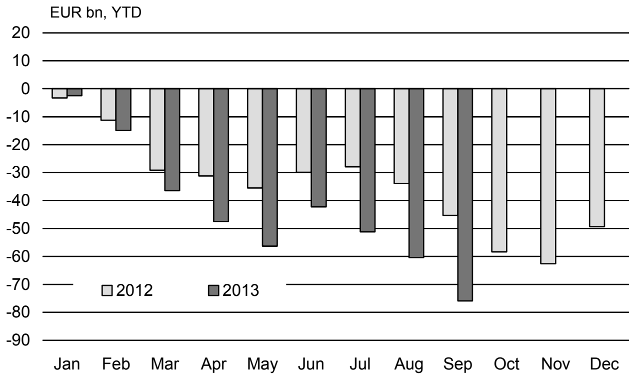
- We continue to expect an easing in the pace of industrial recession in 3Q13.

CAR REGISTRATIONS



- After the big jump in 2Q13, car registrations (seasonally adjusted) showed a correction in 3Q13 (-5.1% qoq).

STATE SECTOR BORROWING REQUIREMENT (I)



- In January-September 2013, the budget deficit amounted to EUR 76bn vs. EUR 45bn in the same period last year.

STATE SECTOR BORROWING REQUIREMENT (II)

SSBR of January-July 2013 (latest data available)

	2012	2013
EUR bn		
Revenues	264.2	271.1
of which revenues net of interest received	*263.2*	*270.3*
Expenditures	292.1	309.2
of which expenditures net of interest paid	*248.5*	*268.3*
Primary deficit (-)/surplus (+)	14.7	2.0
Net interest payments	42.6	40.2
Deficit (-)/surplus (+), net of financial accounts	-28.0	-38.2
Financial accounts	0.1	-13.1
State sector budget deficit (-)/surplus (+)	**-27.9**	**-51.2**

- In January-July 2013, the worsening in the financial account balance (worth EUR -13bn) accounts for about 60% of the cumulative fiscal slippage (EUR -23.3bn).

Source: ISTAT, ANFIA, MEF, UniCredit Research

Spain

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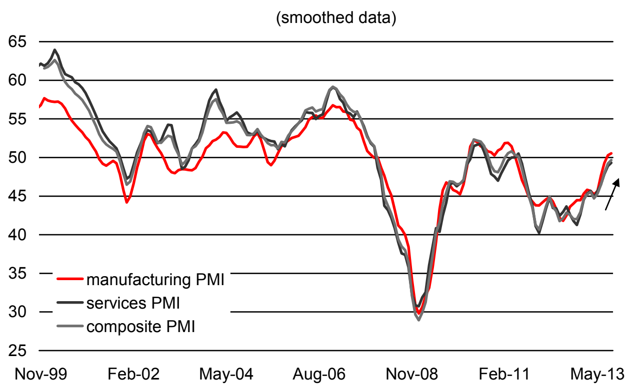
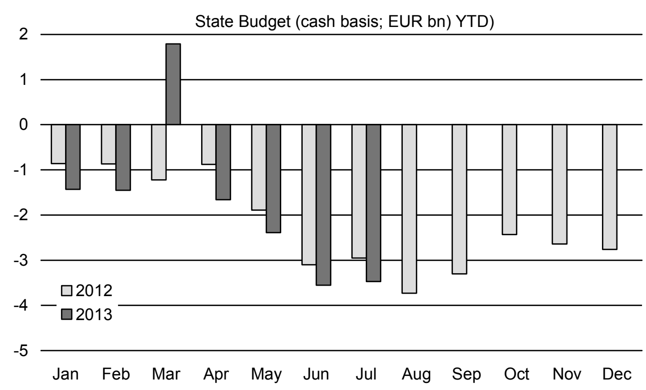
- Recent data suggest that the growth outlook has continued to gradually improve in the third quarter, following a stronger-than-expected GDP performance in 2Q, when GDP came in at -0.1% qoq vs -0.4% qoq in 1Q. The pace of improvement in the latest business surveys and the fair resilience in industrial production up to August suggest that GDP may have stabilized or even marginally increased in 3Q, hinting at some upside risks to our -0.1% 3Q GDP forecast. If this is correct, Spain would exit recession only one quarter earlier than we expected. Consequently, this would not have any meaningful impact on our outlook for the country. Our baseline scenario foresees a gradual, soft GDP recovery setting in before the year's end and becoming more entrenched in 2014. Export growth is likely to remain the main engine of growth and is likely to partially offset persistent weakness in final domestic demand as a result of a still-incomplete rebalancing process of the economy out of non-tradable sectors, especially construction. In turn, this healthy export performance, together with improved profitability among firms, will most likely continue to fuel the ongoing recovery in capital expenditure, which rose by a cumulative 3.8% in 1H13. However, in the near term, this is likely to be the only bright spot across domestic demand components.

- The government recently presented the draft budget law for 2014. The document targets a reduction in the nominal deficit from 6.5% in 2013 to 5.8% in 2014. This forecast relies on the assumption that real GDP growth will accelerate from -1.3% in 2013 to +0.7% in 2014 on the back of firming external demand. The 5.8% target confirms the commitment to fiscal retrenchment agreed upon with the European Commission last spring, when Brussels conceded a two-year extension to bring the nominal deficit below 3%. The bulk of the structural fiscal effort will be focused on the expenditure side, although the budget details lack the granularity needed to precisely quantify the overall size of the effort (which we expect to be slightly below 1% of GDP, in line with EC recommendations). The main discretionary measures consist of the continued freeze in public sector hiring and wages, a further 4.7% reduction in ministerial spending and a change to the method under which pensions are revalued each year in order to reduce the pension deficit. From 2014 onwards, pension payments will rise by a minimum of 0.25% every year, while maximum increases will be capped at inflation rates plus a 0.25% top-up. All in all, we continue to see the risk of a mild slippage in the 2014 deficit from the 5.8% target, mainly as a result of our 0.4% GDP forecast, which is less optimistic than that of the government (0.7%), and, to a lesser extent, the increasing likelihood that this year's deficit may slightly exceed the 6.5% target. However, the European Commission will most likely keep focusing on the pace of reduction of the structural rather than the nominal deficit.

PMIS KEEP POINTING NORTH



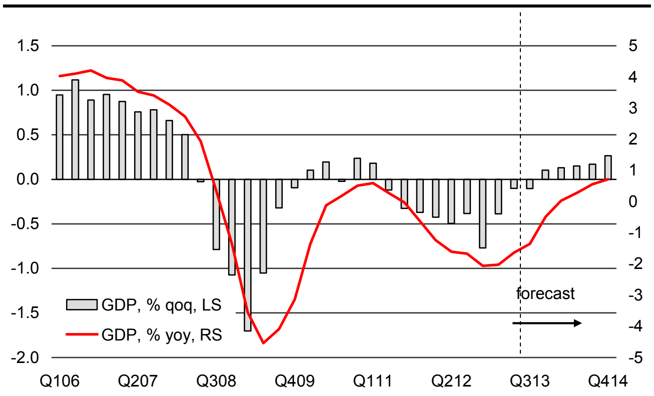
ONE-OFF FACTORS WEIGHING ON BUDGETARY PERFORMANCE



Source: Markit, Ministry of Finance, UniCredit Research

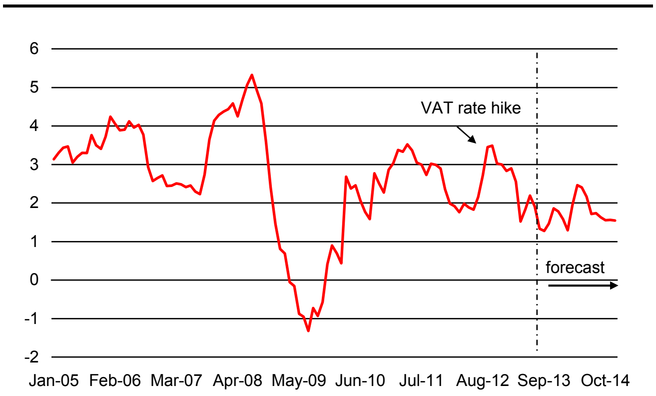
Spain

GDP



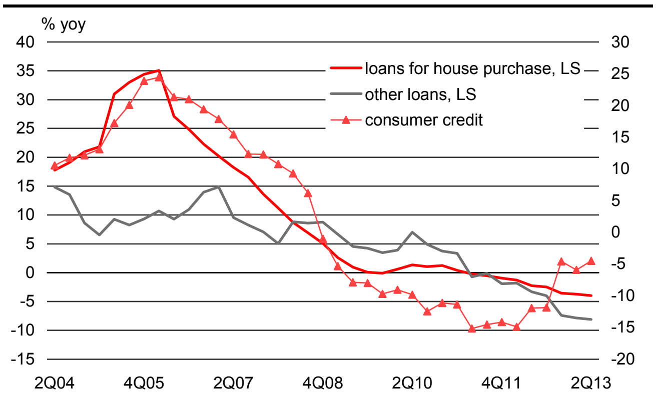
- The pace of recession eased further in 2Q13 and we expect GDP to return to positive territory by the end of the year.

INFLATION



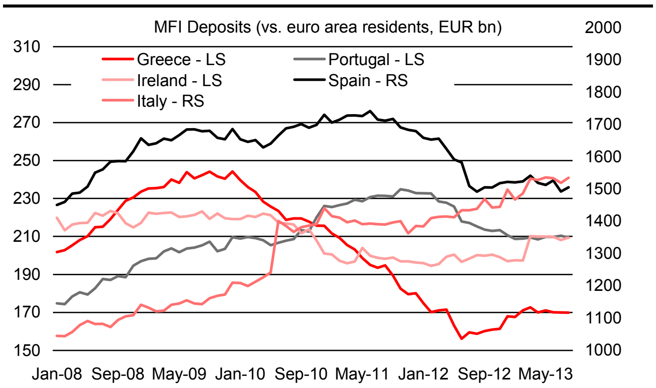
- We see inflation settling at 1.9% in 2013 and 1.8% in 2014.

HOUSEHOLD CREDIT GROWTH



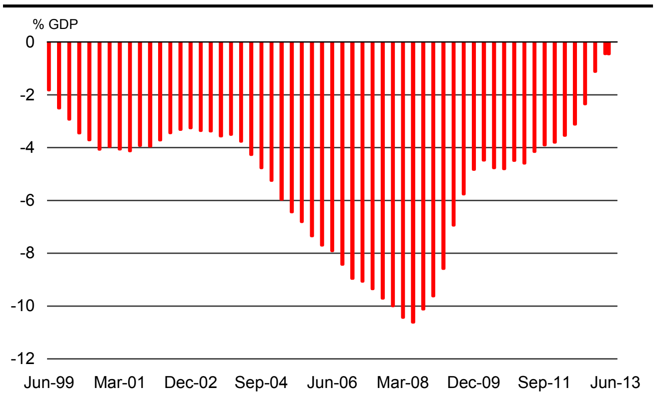
- The contraction in lending to households took a breather in 2Q13, mainly due to a pick-up in loans for consumer credit.

BANK DEPOSITS



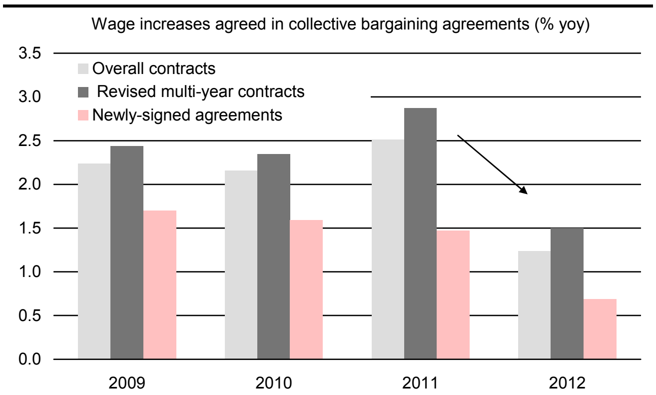
- The decline in deposits came to a halt in August 2012 and we have since been witnessing a broad stabilization.

CURRENT ACCOUNT



- The current account deficit has been shrinking steadily, settling at only 0.4% of GDP at the end of 2Q13.

NEGOTIATED WAGES



- Reforms of the collective bargaining framework have started to bear fruit.

Source: Bank of Spain, Eurostat, INE, UniCredit Research

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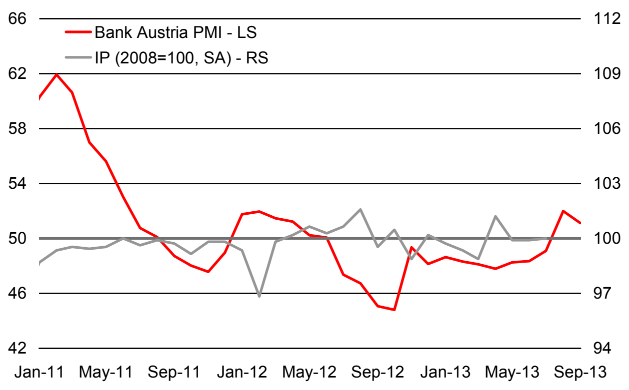
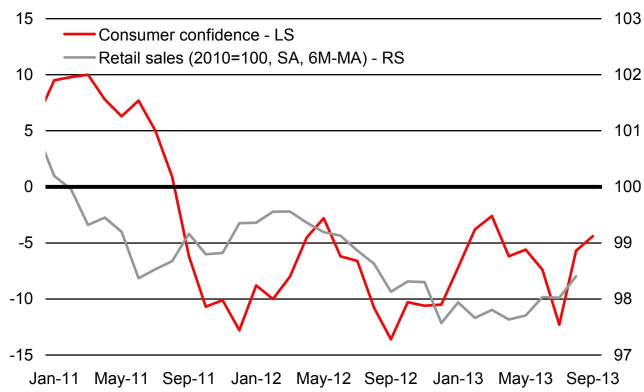
unicreditgroup.at

- Despite losing a bit of momentum recently, the upward trend in Austrian industry continues. The Bank Austria Purchasing Managers' Index sank by 0.9 points to 51.1 in September. Despite this moderate deceleration from the previous month, our survey of Austrian industrial purchasing managers indicates that the pace of growth in September was relatively solid. After the sector posted declines or, at best, stagnation for over a year, the index now points to an upturn in Austrian production for the second month in a row. Production output expanded significantly again in September, although growth in new orders was limited. The moderate development of demand kept the increase in costs low and was too weak to create additional jobs, but the pace of job cuts has already slowed considerably.
- Growing optimism in industry in recent months has spilled over to Austrian consumers. Confidence among domestic consumers improved in August and September, albeit from a very low level. Supported by falling inflation, retail sales started to recover at the beginning of 2H 2013. However, as in the two previous years, the segment as a whole is likely to have contracted in real terms in 2013. Nevertheless, we think the export-driven economic growth path in Austria will be increasingly supported by consumption and investments. We still expect GDP to grow by 0.4 % in 2013 and by 1.8 % in 2014.
- Falling to 1.8 % yoy in August, inflation continued its downward trend which began at the end of 2012. Although they continued to be fuelled by foodstuffs and rents in August, prices in these areas rose more slowly than in the previous month. Prices for fuel, on the other hand, dampened inflation, compared to the previous year. The decline in inflation will probably accelerate in the next few months. As a whole, it is likely to average no more than 1.9 per cent in 2013, as any upward pressure from commodity prices will remain moderate in light of the gradual pace of recovery in Europe and weaker growth in developing countries.

AUSTRIAN INDUSTRY TO START UPWARD TREND



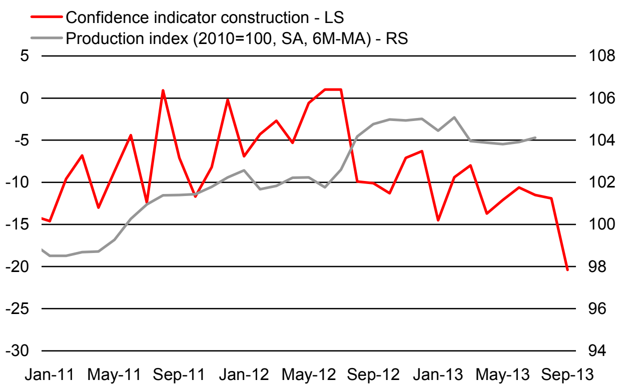
IMPROVED CONSUMER SENTIMENT HELPS RETAIL TRADE



Source: Statistik Austria, Markit Research, UniCredit Research

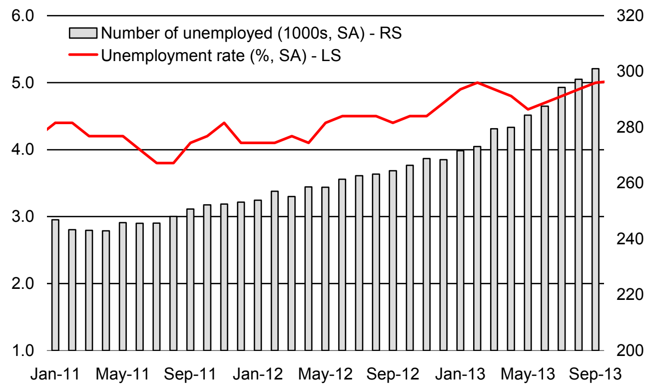
Austria

CONSTRUCTION



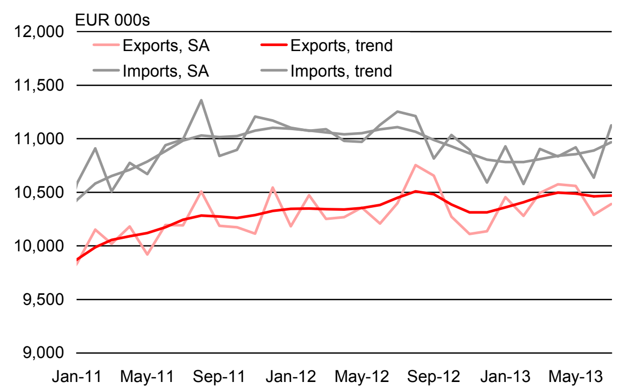
- The trend in construction in the first half 2013 was marked by slightly negative production and falling sentiment

LABOR MARKET



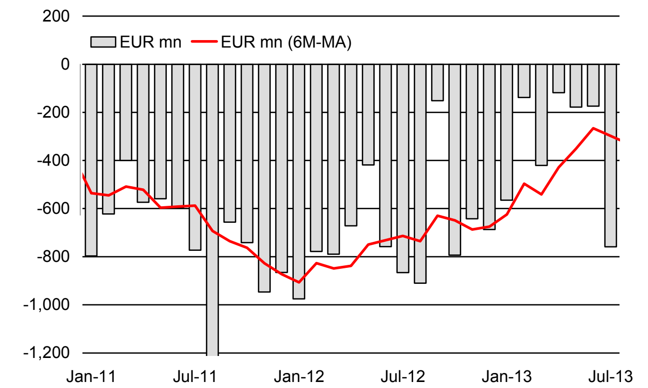
- While the negative trend on Austria's labor market is clearly discernible, it is within limits from an international perspective.

EXPORT AND IMPORT VOLUME



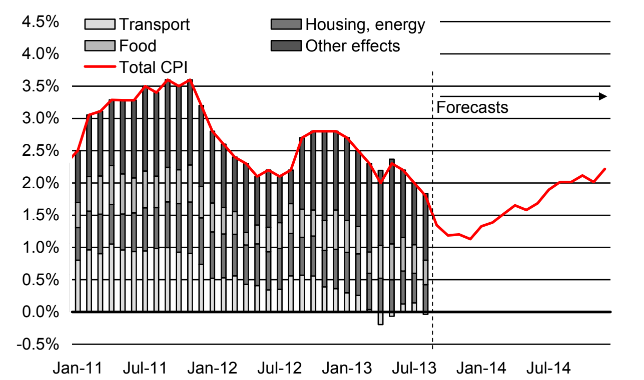
- Exports continue to experience only moderate growth improvement in order books, raising prospects.

MERCHANDISE TRADE BALANCE



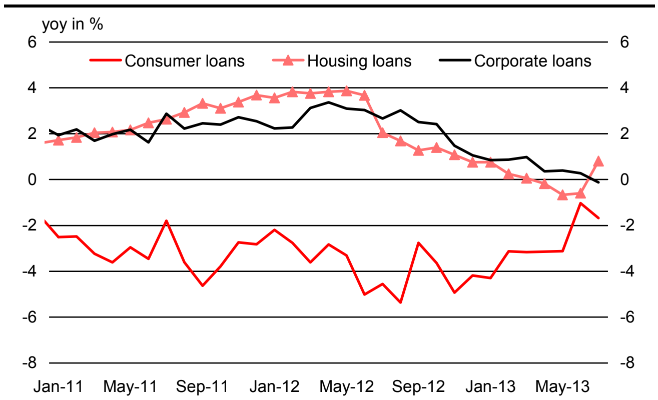
- The trade deficit, estimated at 1.6 % of GDP in 2013, should be well below the previous year's level.

INFLATION



- The decline in inflation will accelerate in the next few months due to weaker upward pressure from commodity prices.

LENDING TO HOUSEHOLDS AND CORPORATES



- The downward trend in corporate loans growth still persists.

Source: Statistik Austria, UniCredit Research

Greece

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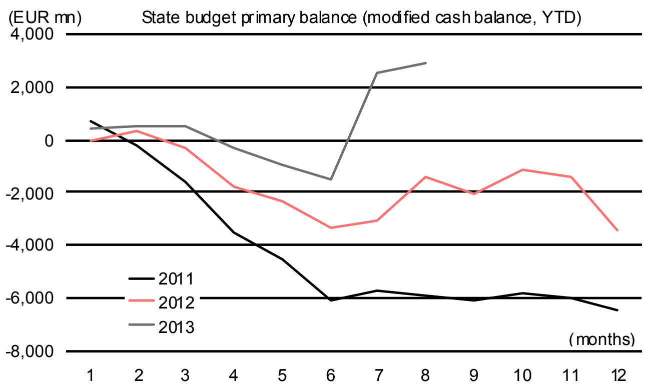
- Since the Troika's mission chiefs left Athens for a "technical pause", the Greek government has been busy completing the actions required by its lenders to resume policy discussions later this month and approve the disbursement of the next loan tranche installment by end-October. The most pressing issue that the government had to face was certainly the finalization of a preliminary 2014 draft budget by October 7, when the constitutional deadline for the budget submission to Parliament fell due. The preliminary document targets a general primary surplus – excluding ANFA and SMP profit transfers, most sales of non-financial assets, and costs related to bank resolutions and recapitalizations – of EUR 2.8bn (1.5% of GDP) for next year, compared to EUR 300mn (0.2%) this year. However, it is likely that these numbers will be the subject of further discussion by the Troika as soon as it returns to Athens (most likely after the Eurogroup meeting scheduled on 14 October). The Troika had already expressed skepticism about the possibility that the 1.5% surplus could be achieved and, most importantly, that it did not require any additional fiscal measures as the government projects. The Troika actually expressed some doubts about the government's revenue estimates from the unified property tax that will enter into force next year, as well as the effectiveness of measures undertaken to address the shortfall in the social security deficit. On top of the 2014 budget, additional pending issues relate to the finalization of restructuring/downsizing of Hellenic Vehicle Industry/ELVO, Hellenic Defense System/HDS, and General Mining and Metallurgical Company/LARCO and the Troika's evaluation of the new code for lawyers recently voted on in Parliament.

- As soon as the loan tranche disbursement issue is settled, discussions could then focus on the envisaged shortfalls in the financing program for 2014 and 2015. Our baseline scenario is that the Troika will focus on covering the 2014 EUR 4.4bn financing shortfall before the end of the year and postpone discussions about how to finance the 2015 shortfall to sometime next year. Specifically, we expect that the 2014 shortfall will be addressed without committing to fresh financing in the form of new loans, provided its size does not depart significantly from the current estimate. This is also in line with the recent statements by Eurogroup chief Dijsselbloem who qualified his acknowledgment that Greece may need further assistance by saying, "He was not speaking of a new loan".

- On the political front, the government recently undertook several initiatives to effectively outlaw the extreme-right Golden Dawn party by asking prosecutors to declare it a criminal organization. This happened after several members were arrested following the killing of an anti-fascist rapper by a self-professed member.

STATE BUDGET PRIMARY BALANCE MOVED INTO SURPLUS



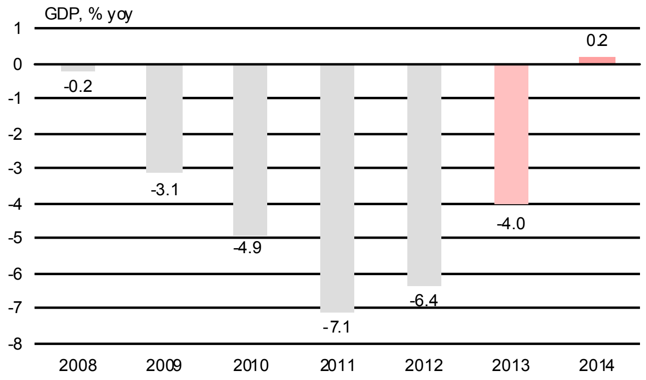
MEDIUM-TERM FISCAL PROJECTIONS IN THE MEMORANDUM

In % of GDP	2012	2013	2014	2015	2016
Primary balance	-1.3	0.0	1.5	3.0	4.5
General government balance	-6.3	-4.1	-3.3	-2.1	-0.8

Source: Greek Finance Ministry, European Commission, UniCredit Research

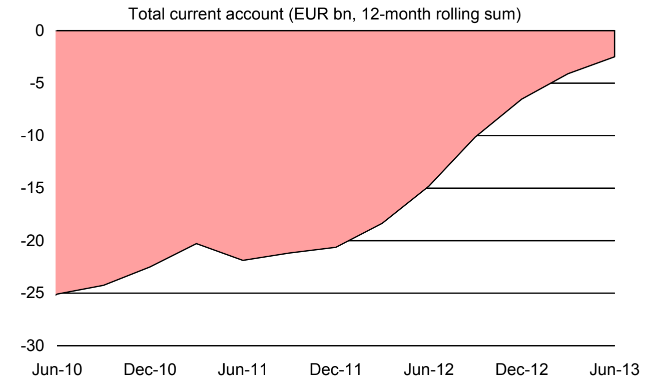
Greece

GDP



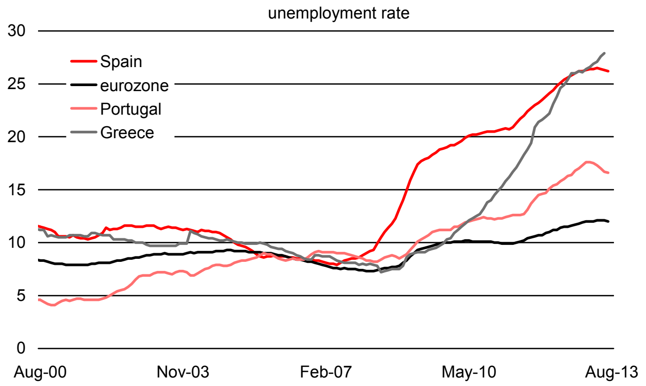
■ Greece may exit recession next year.

CURRENT ACCOUNT



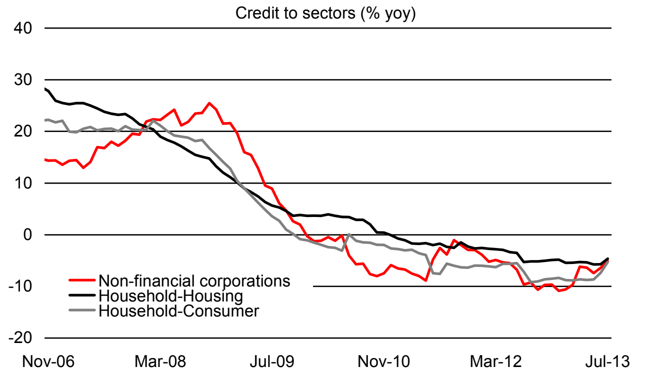
■ The current account deficit has been shrinking steadily and settled at nearly EUR 2.5bn in June.

UNEMPLOYMENT



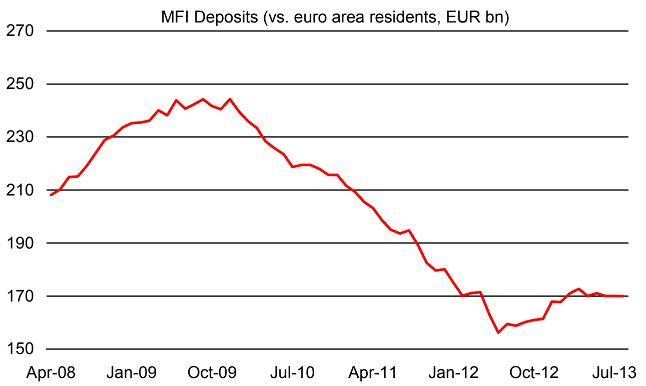
■ The increase in the unemployment rate has shown no letup.

CREDIT GROWTH



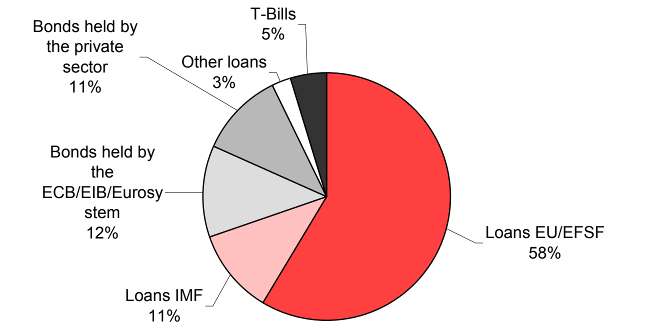
■ The pace of contraction in credit to the private sector continues to ease, albeit gradually.

DEPOSITS



■ There has been an inflow of deposits since last summer.

GENERAL GOVERNMENT DEBT BY INSTRUMENT



■ The bulk of the debt stock is in the hands of Greece's official creditors.

Source: Elstat, EC, Eurostat, ECB, Central Bank of Greece, UniCredit Research

Portugal

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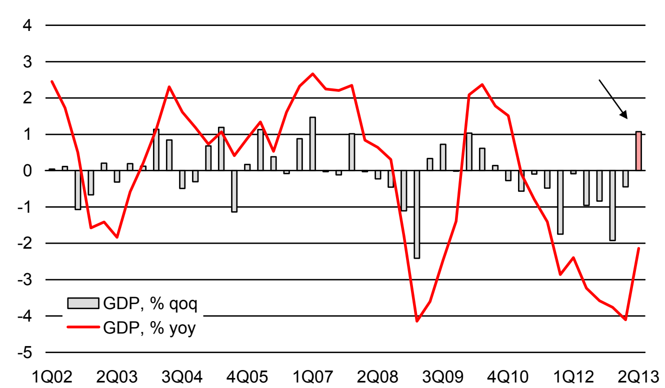
- The timely (and successful) conclusion of the Troika's ninth review on 3 October came as a positive surprise, following seemingly persistent divisions within the government about the appropriate fiscal stance, which intensified just before the arrival of the Troika's mission chiefs to Lisbon due to Constitutional Court rulings that blocked key policy measures for 2014. The Troika eventually made the fulfillment of the 4% deficit-to-GDP target for 2014 (from 5.5% in 2013) a sticking point in the negotiations, dismissing calls for a further 0.5pp relaxation of the target. Incidentally, Mr. Draghi recently firmly opposed any relaxation of the Portuguese 2014 deficit target, saying that it risked triggering a brutal reaction from markets and thus jeopardizing the efforts already undertaken. Previously agreed-upon cuts to public expenditure will remain of essence to achieve the deficit target, although the Troika's statement made no mention about the need to identify new measures for replacing those declared unconstitutional. It simply highlighted the increasing risks to the economic outlook and prospects for a sustained return to markets in the event that some of the fiscal measures still waiting for the court's assessment (i.e. the alignment of public sector working hours with those in the private sector) were judged unconstitutional.
- The overall tone of the statement was sanguine about future growth prospects (GDP was revised up from -2.3% to 1.8% for 2013 and from +0.6% to +0.8% for 2014), recent progress on fiscal consolidation (with the 2013 deficit target looking within reach) and structural reforms. Importantly, the Troika explicitly stated that the public debate "remains sustainable", thereby dismissing speculation about PSI prospects that had put strong pressure on PGB yields ahead of the Troika's arrival. The Troika expects debt to peak at 127.8% of GDP this year (compared to 122.9% forecasted at the end of the seventh review) and decline thereafter. Note that the mild upward revision to the 2013 debt-to-GDP figure was mainly due to factors that do not pose any material challenge to the underlying debt dynamics (i.e. larger-than-expected treasury cash balances, most likely due to the Troika's demand for building up precautionary buffers).
- As we write, the government is in the process of finalizing the 2014 budget law, which should be presented to Parliament by 15 October. A timely finalization of the fiscal package is needed to obtain the disbursement of the next EUR 5.6bn loan tranche (EUR 3.7bn by the EU and EUR 1.9bn by the IMF) in early November. As agreed on in the previous review, structural measures hinging on public expenditure reduction (i.e. reduction of the public sector wage bill and of pension benefits, and sectoral expenditure cuts across line ministries) will have to amount to 2.0% of GDP. We understand that temporary measures set to expire this year (including the extraordinary solidarity contribution on pensions) will be extended to 2014. Given the size of the fiscal effort required, we think that the new 2014 GDP forecast by the Troika is likely to prove too optimistic.

SURPRISINGLY STRONG GDP REBOUND IN 2Q13



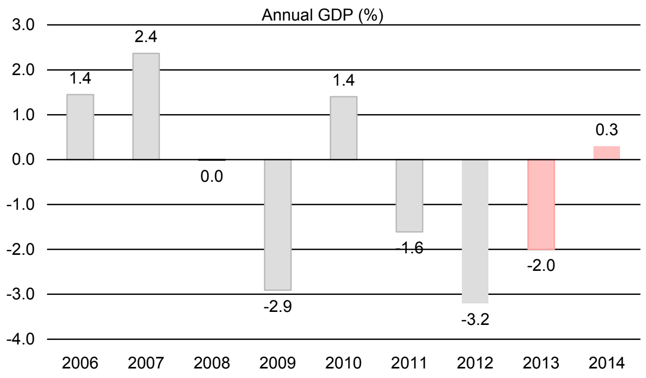
PUBLIC EXPENDITURE MEASURES (AS PER THE 7TH REVIEW)

(in millions of euros, on a cumulated basis)	2013	2014	Total
Wage bill	777	1,395	2,172
Special mobility (requalification)	48	119	167
Convergence public-private working rules	176	365	541
Mutual agreements (voluntary separation)	0	252	252
Single wage and supplement scale	0	445	445
Termination of fixed-term contracts	74	214	288
Attrition	479	0	479
Pensions	0	1,378	1,378
Increase in retirement age	0	270	270
Equality between public sector and private sector schemes	0	672	672
Sustainability contribution	0	436	436
Intermediate consumption	334	520	854
Savings from the line ministries	284	470	754
Other	50	50	100
Other	300	-4	296
Total	**1,411**	**3,289**	**4,700**
in percent of 2013 GDP	*0.9*	*2.0*	*2.9*

Source: INE, IGCP, UniCredit Research

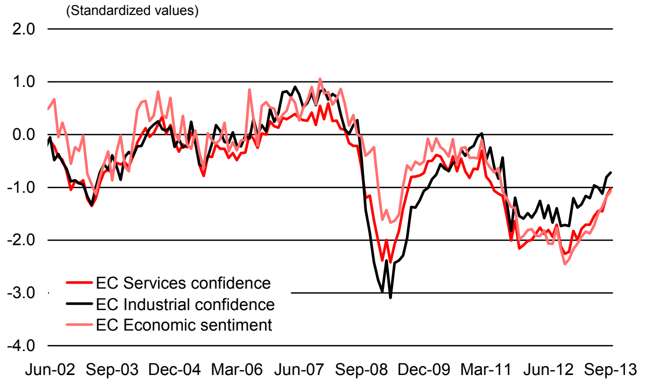
Portugal

GDP



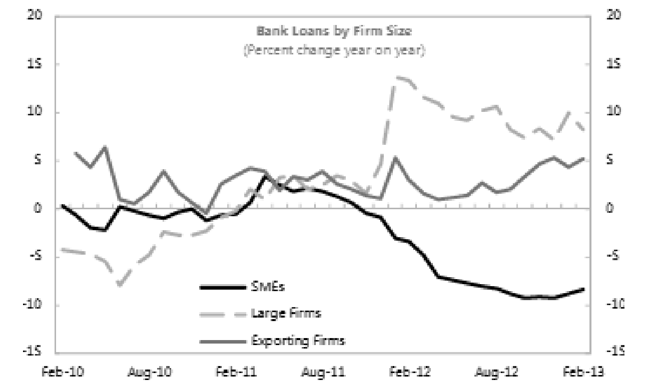
- We expect GDP to contract by 2.0% in 2013 and return to positive growth in 2014 (at an average annual pace of +0.3%).

SURVEYS



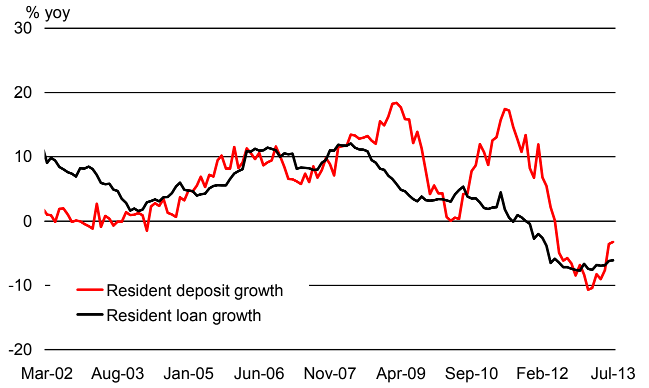
- Sentiment has been improving steadily, especially in the industrial sector.

BANK LOANS BY FIRM SIZE



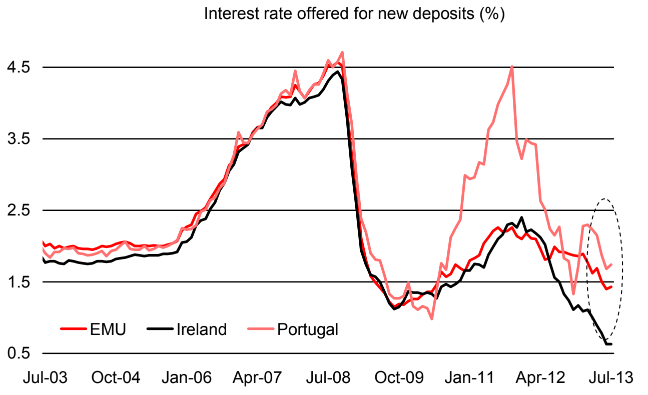
- Credit to SMEs remains difficult.

DEPOSIT AND LOAN GROWTH



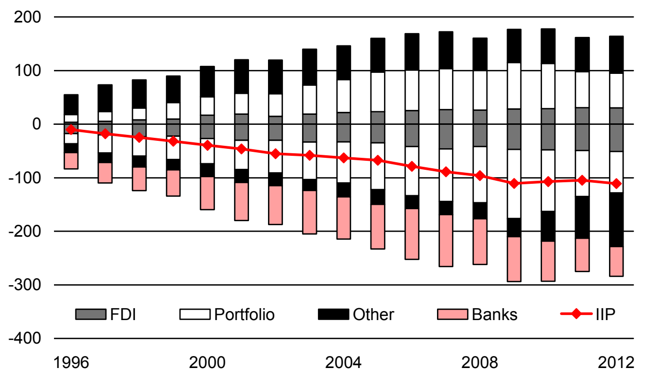
- The pace of contraction in deposit growth has been easing since April…

DEPOSIT RATES



- …although interest rates on new deposits have been declining.

NET IIP



- External deleveraging is only just beginning.

Source: INE, Bank of Portugal, UniCredit Research

UK

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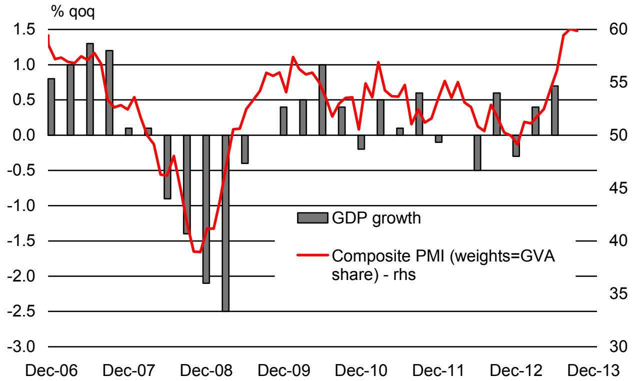
- The economic recovery is gaining traction as more survey indicators point to faster growth in 3Q13 than the 0.7% qoq growth recorded in 2Q13. The headline PMIs eased marginally in September but remained at very elevated levels. The services PMI came in at 60.3 (-0.2 mom), the manufacturing PMI at 56.7 (-0.5 mom), and the construction PMI at 58.9 (-0.2 mom). Growth is predominantly coming from private consumption, driven by better employment expectations, house price rises (via the wealth effect) and low interest rates. We maintain our real GDP growth forecast of 0.9% qoq in 3Q13, and annual growth of 1.6% this year and 3.1% next year, which is well above consensus (consensus: 1.3% in 2013 and 2.1% in 2014).

- There are a number of risks to our GDP growth forecast. First, the upbeat survey data has yet to be fully reflected in the hard data. In particular, industrial production unexpectedly dropped 1.1% mom in August; however, we think this is likely to be a statistical outlier and expect a bounce in the September figure. External shocks, notably the US shutdown and tapering, could put the recovery at risk. Meanwhile, the sharp appreciation of sterling since early July will likely weigh on exports.

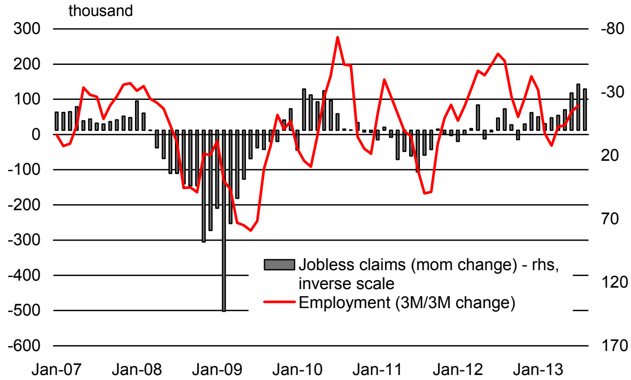
- We remain concerned that the economic recovery is unbalanced in favor of private consumption, in part fueled by house price gains. The government brought forward the second phase of its Help-to-Buy scheme by three months. The program, which means a person can buy a home up to the value of GBP 600,000 with just a 5% deposit, has already come into effect with six lenders signing up. Despite lenders charging large spreads (in part to recoup a fee they pay to the government), the scheme is highly likely to further fuel house price rises, which, according to Nationwide, rose 5% yoy in September. Meanwhile, lending to business remains subdued and business investment fell in 2Q13.

- The BoE's MPC meeting last week (10 October) was predictably a non-event: the MPC kept the bank rate at its historical low of 0.50% and the volume of its bond purchases at GBP 375bn. In its forward guidance of 7 August, the central bank said it would not increase the bank rate and does not plan to reduce the stock of asset purchases until the unemployment rate, currently at 7.7%, drops to 7%. We expect the unemployment rate to fall to 7.6% when it is released on 16 October and that it will reach the 7% threshold by end-2014.

THE COMPOSITE PMI SUGGESTS GROWTH WILL ACCELERATE



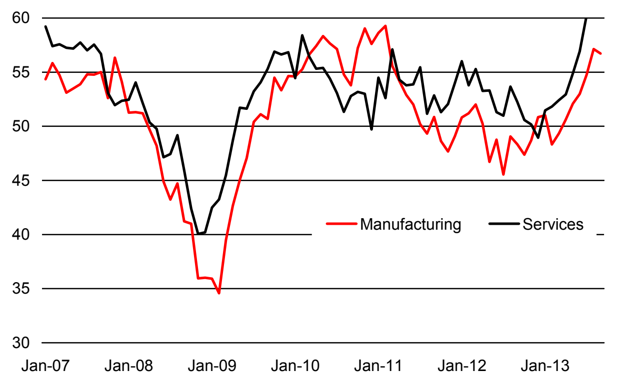
JOBLESS CLAIMS SIGNAL A RISE IN EMPLOYMENT



Source: ONS; Markit; UniCredit Research

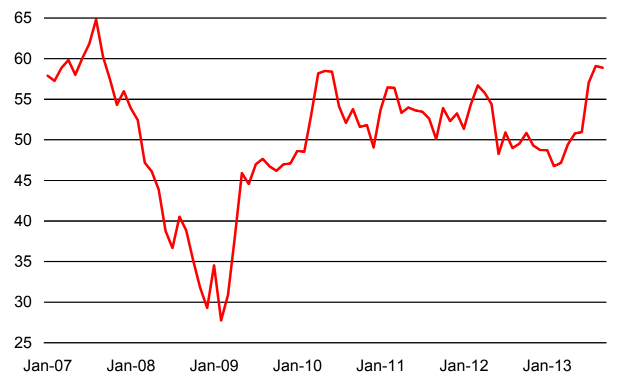
UK

PMIS



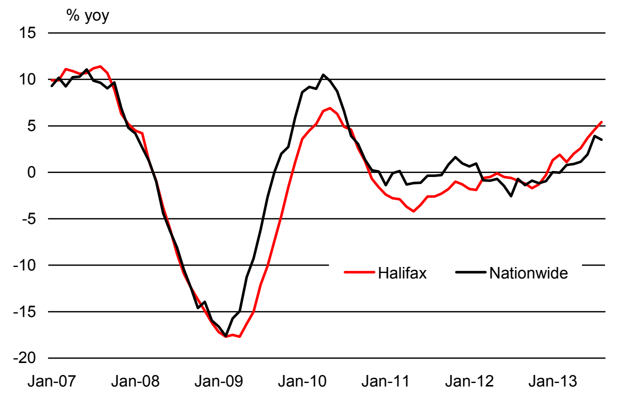
- Both the headline Manufacturing and Services PMI eased slightly in September but remain at high levels.

CONSTRUCTION PMI



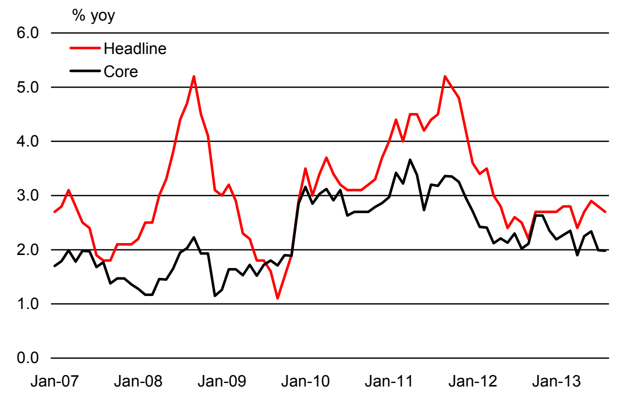
- The Construction PMI eased marginally but remains close to a six-year high.

HOUSE PRICES



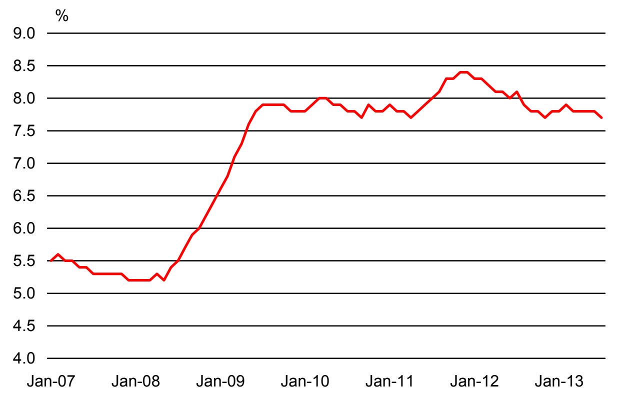
- House prices continue to accelerate.

INFLATION



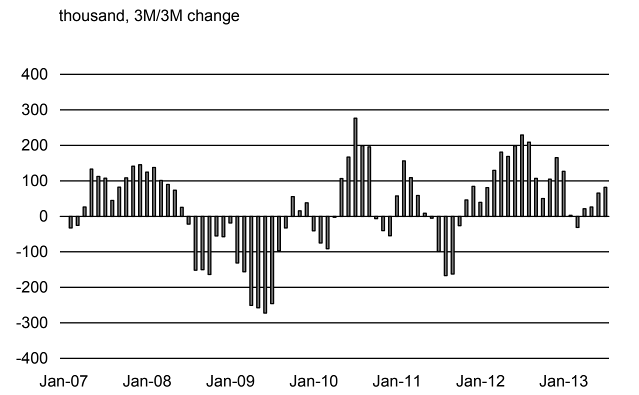
- Headline inflation eased slightly in August to 2.7% yoy from 2.8% yoy in July. Core inflation remained at 2.0% in August.

UNEMPLOYMENT



- The unemployment rate dropped to 7.7% in July.

EMPLOYMENT



- Employment increased a strong 80,000 on a 3M/3M basis in July.

Source: ONS; Markit; UniCredit Research

Sweden

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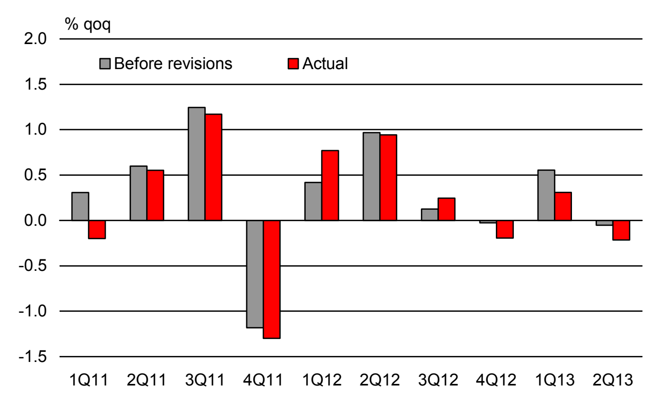
- According to the second 2Q13 GDP estimate, the Swedish economy contracted by 0.2% qoq, more than the -0.1% qoq reported in July. Among the factors leading to the downwards GDP revision was foreign trade, as the quarterly contribution from net exports fell from -0.1pp to -0.3pp, more than offsetting positive contributions coming from government and household consumption, whose quarterly growth rate was revised up to 0.2% (vs. -0.1%). The 2Q13 estimate also included sizable revisions to previous quarters for the period from 1Q11 to 1Q13. In particular, 1Q13 GDP growth was lowered from 0.6% qoq to 0.3%. Lower 1Q and 2Q figures led us to reduce our 2013 GDP growth forecast from 1.3% to 0.8%. Our forecast for 2014 GDP growth remains unchanged at 2.6%.

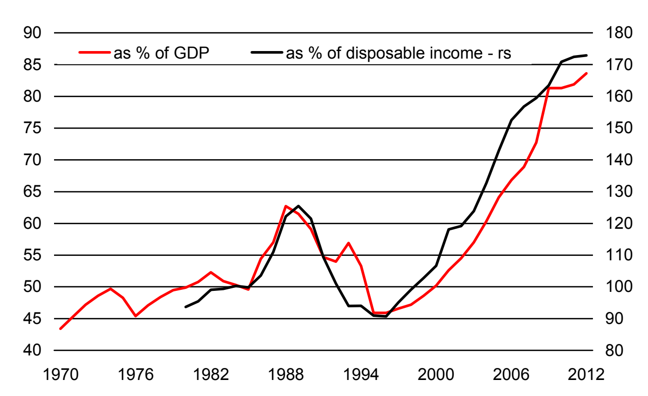
- Recent soft and hard data signal healthy economic expansion in 3Q. In September, manufacturing PMI jumped to its highest level in more than two years, rising from 52.2 to 56.0, while the NIER manufacturing confidence index fell (following a rise of around six points from July to August) from 100.7 to 94.2. However, since sentiment series have proved to be very volatile in recent months, we get a more precise picture by looking at three-month moving averages. On this basis, manufacturing PMI rose from 51.7 in 2Q to 53.2 in 3Q, while NIER manufacturing confidence improved from 93.2 to 96.6. On the hard-data front, industrial production (IP) decreased by 2.3% mom in August, while production in the services sector (SPI) rose 1.5% mom. In July-August, both IP and SPI were 1.5% and 0.2% higher, respectively, than the 2Q average. Together these data signal that both the industrial and services sectors were probably already on their way out of recession in 3Q.

- The elevated household indebtedness remains the main cause for concern for the Riksbank (RB), as highlighted in the minutes of the September meeting. The RB welcomed the government's proposal to introduce a framework for macroprudential policy and stated that it will, however, carefully monitor developments in household debt and credit growth until the new measures become operational. Meanwhile, members agreed that there is a link between macroprudential policy and monetary policy and that new measures could impact future monetary policy decisions. In other words, household indebtedness will inevitably continue to influence future monetary policy considerations. The way in which monetary policy is affected when the new macroprudential policy measures are implemented will depend on both economic development and financial stability and the risks linked to high household indebtedness. As regards future rate decisions, we think that any new macroprudential measures and their impact could add some uncertainty to the repo rate forecasts. Nevertheless, we continue to expect the Riksbank to keep the repo rate at 1.00% until 3Q14 and to start the monetary tightening cycle thereafter.

REVISIONS TO QUARTERLY GDP GROWTH RATES



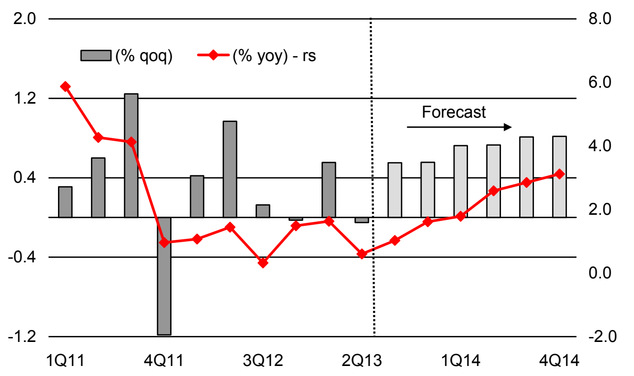
HOUSEHOLD INDEBTEDNESS IS VERY HIGH



Source: Riksbank, Statistics Sweden, UniCredit Research

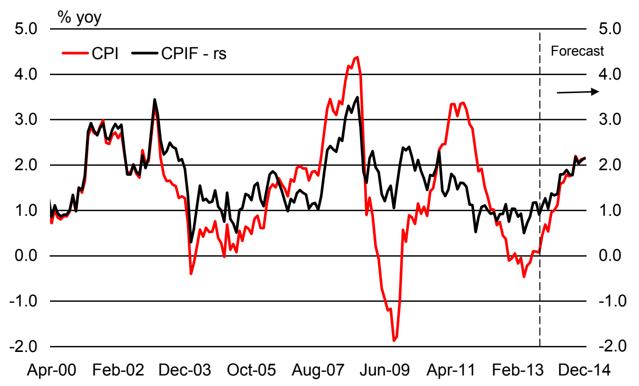
Sweden

OUR GDP FORECASTS



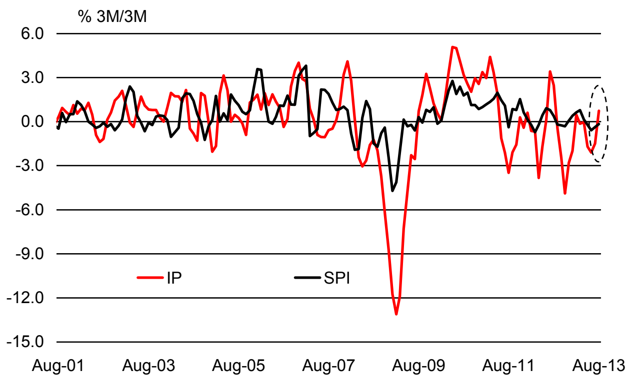
- We expect GDP figures to show 0.6% qoq expansion both in 3Q and 4Q.

INFLATION



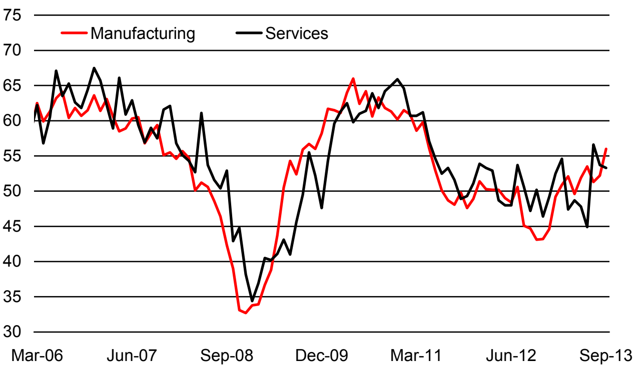
- CPI inflation was stable at 0.1% for the third consecutive month in September, while CPIF inflation slowed to 0.9% (from 1.2% previously).

INDUSTRIAL AND SERVICE PRODUCTION



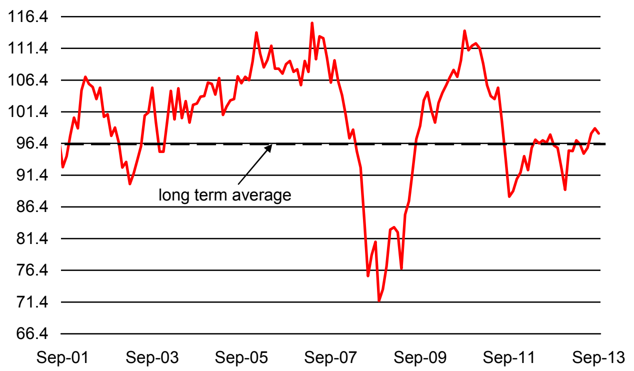
- IP declined by 2.3% mom in August, while SPI increased by 1.5% mom. The 3M/3M growth rate was 0.7% for IP and -0.2% for the SPI.

PMIS



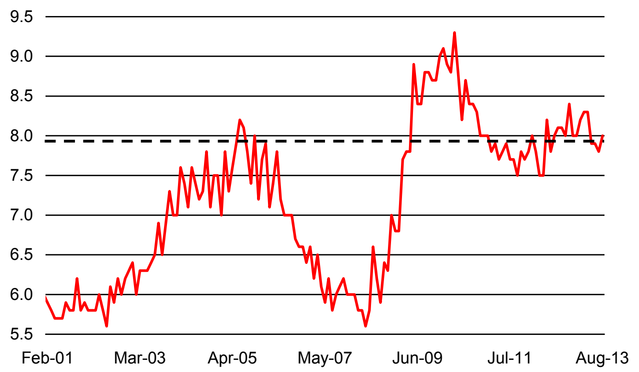
- In September manufacturing PMI rebounded from 52.2 to 56.0, while services PMI fell from 53.7 to 53.3.

CONSUMER CONFIDENCE



- Consumer confidence fell in September, from 98.8 to 98. The index remains, however, above its long-term average.

UNEMPLOYMENT RATE



- The seasonally-adjusted unemployment rate returned to 8% in August, after a decline to 7.9% in July.

Source: NIER, Statistics Sweden, Swedbank and Silf, UniCredit Research

Poland

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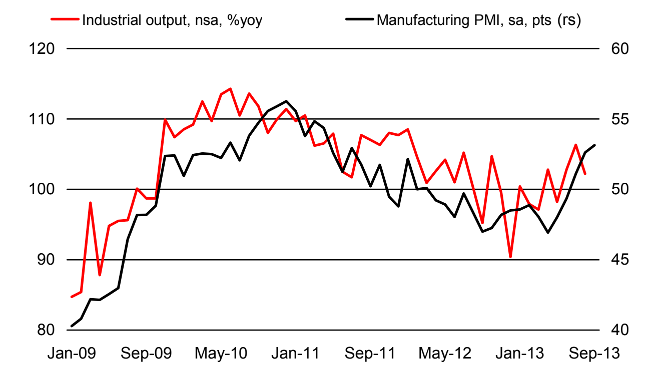
- The data released in the coming weeks is very likely to strengthen the picture of an accelerating economy. The first positive signal in recent days was the PMI increase to 53.1 from 52.6 and the structure of growth was particularly promising, with the increase mostly propelled by a significant improvement in employment and an increase in delivery times of suppliers, due to increasing demand and shortages of some supplies at producers (who apparently underestimated demand). This suggests a revival of demand in the economy.
- Industrial output is expected to grow by 8.3% yoy (following 2.2% yoy in the previous month, though one should keep in mind the positive impact of the number of working days this time, and negative impact on the previous figure). Retail sales growth is likely to accelerate to ca. 5.0% yoy (vs 3.4% yoy previously). Data from the labor market should start to confirm the positive message from PMI-labor report. We expect an improvement in the level of employment in the corporate sector, from -0.5% yoy in August to -0.3% yoy in September, and an acceleration of wages from 2.0% yoy in August to 3.0% yoy in September.
- We expect CPI inflation to stay unchanged at 1.1% yoy, with PPI declining further (to -1.6% yoy, vs -1.1% yoy in the previous month). The low level of inflation, combined with MPC rhetoric clearly signaling lack of interest rate changes at least till year-end, means that the upcoming MPC meetings will have little impact on the markets. NBP President Marek Belka avoided making a statement on the stance of monetary policy and changes to its parameters in 2014. It is likely that the MPC will start to discuss this issue more precisely after the release of November NBP inflation projection.
- We maintain our view that the EUR-PLN exchange rate is set to decline in the coming months – our forecast for year-end is unchanged at 4.10-4.15. In the next couple of weeks we expect EUR-PLN to drift towards 4.15. It is worth emphasizing that the government will be keen to see possibly the strongest zloty against the euro at year-end, in order to lower the risk of breaching its 55% debt/GDP threshold. Therefore, it would be unwise to expect zloty weakening in December (seasonal factors also suggest PLN strengthening in December).
- We expect 2Y T-bond yields to stay in 3.20-3.40% range, 5Y in the 3.75-4.00% range and 10Y in the 4.40-4.60% range. Generally, we expect a gradual increase in yields in the coming months.

PMI EMPLOYMENT SHOWS LABOR MARKET RECOVERY IS NEAR

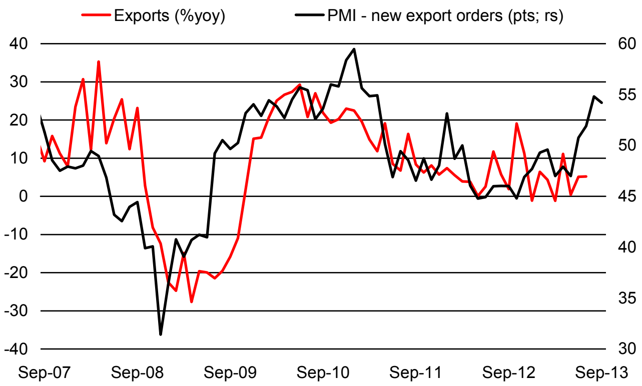
INDUSTRIAL OUTPUT WILL CONTINUE EXPANSION



Source: GUS, NBP, Markit Economics, UniCredit Research

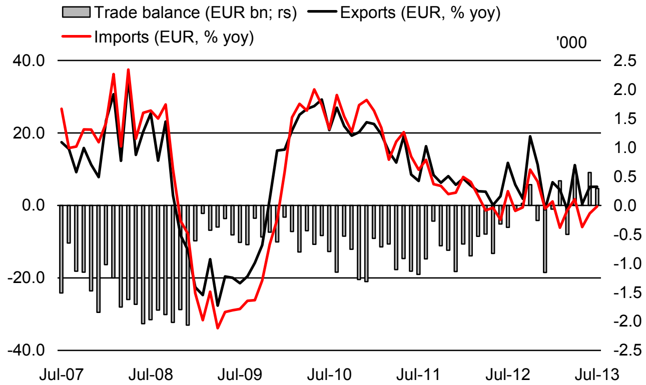
Poland

EXPORTS AND PMI NEW EXPORTS ORDERS



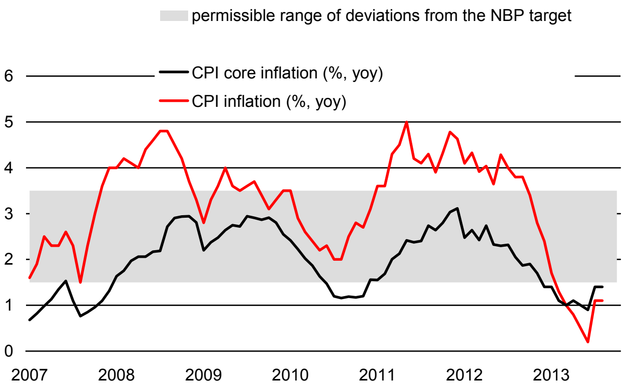
■ Exports should continue to support growth.

EXPORTS AND IMPORTS



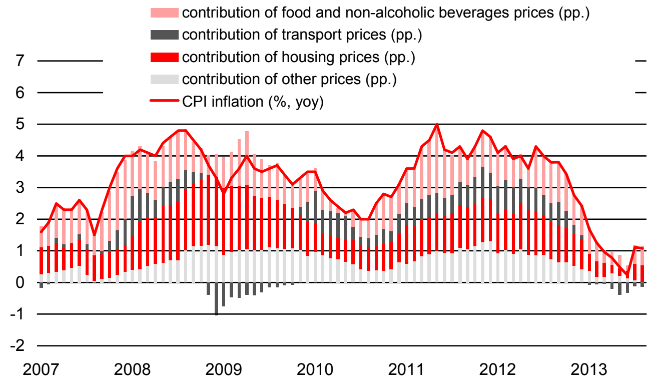
■ Thanks to strong exports, the trade balance turned positive.

INFLATION



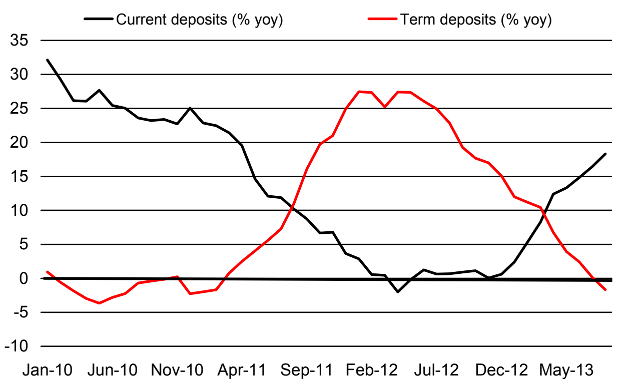
■ CPI is set to enter the MPC fluctuation band by end-2013.

CPI AND CONTRIBUTIONS OF COMPONENTS



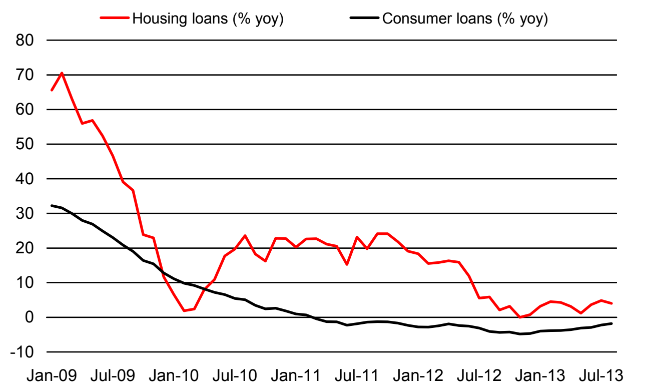
■ Food and housing prices are the primary drivers of CPI growth.

CURRENT DEPOSITS AND TERM DEPOSITS



■ Falling interest rates make term deposits unattractive to savers, who are now switching to current deposits.

HOUSING AND CONSUMER LOANS



■ Growth of loans to households seems to have passed its low.

Source: GUS, NBP, PFSA, Markit, UniCredit Research

Czech Republic

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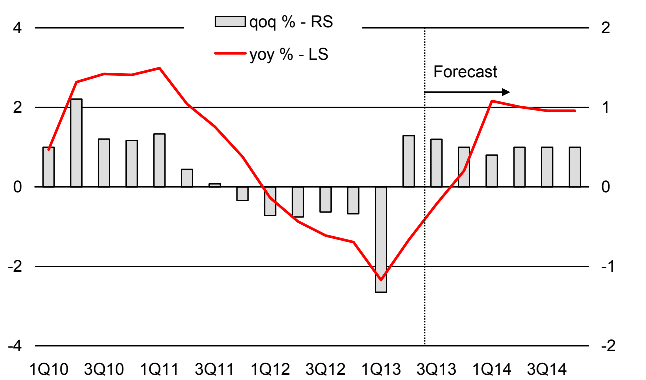
- The interim cabinet of PM Jiri Rusnok approved a draft budget for 2014 which is based on real GDP growth of 1.3%. Higher expenditures on healthcare and salaries of public employees are set to drive the deficit to CZK 112bn in 2014, above the 2013 planned imbalance of CZK 100bn. Hence, fiscal policy may create a moderate stimulus while keeping the deficit just below 3% of GDP. Given the general elections called for October 26-27, it is, however, hardly conceivable that the budget for 2014 will be approved by the new parliament in time. For now, budgetary provisory seems to be unavoidable.

- Headline CPI extended its yoy decline to the fourth consecutive month, posting 1.0% in September. Food, household equipment, telecommunications and package holidays were the key contributors to the overall 0.4% mom drop in the price level, while only clothing and footwear saw their prices rise significantly. With a considerable electricity price decrease in the pipeline, we forecast headline CPI to bottom out as low as 0.5% yoy at the start of 2014. The unexpectedly low inflation is set to bolster private spending, at least in the short run.

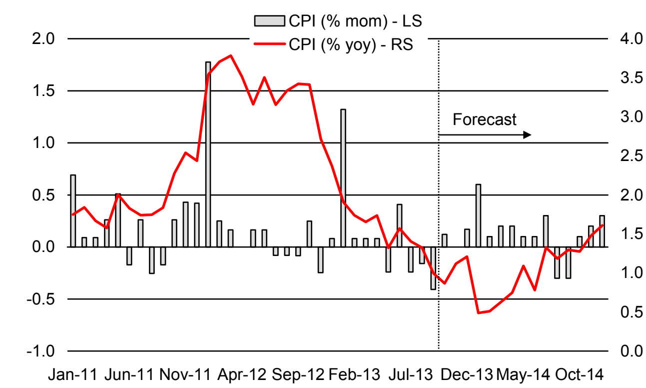
- Industrial output in August surprised on the upside, adding 1.6% yoy (unadjusted) and 4.2% yoy (working day adjusted). The manufacture of motor vehicles expanded by 26.1% yoy, driven by a production kick-off of new Skoda models as well as a shift in company-wide holidays. New industrial orders jumped 15.6% yoy, pointing to further acceleration in industrial output over coming months. The data bode well for our forecast of ongoing GDP expansion in qoq terms in 3Q13.

- At its September meeting, the CNB voted on whether or not to intervene in order to weaken the Czech koruna for the second time; it again rejected the proposal. Policy makers nevertheless concluded that the likelihood of interventions remained constant and rather high. We believe the topic will also stay high on the agenda of the upcoming policy meeting in November. Of the three major aspects possibly affecting the decision, economic activity goes against the urgency of interventions, but the inflation outlook as well as the actual EUR-CZK rate rather support the policy step.

GDP ON AN UPWARD PATH IN 2Q



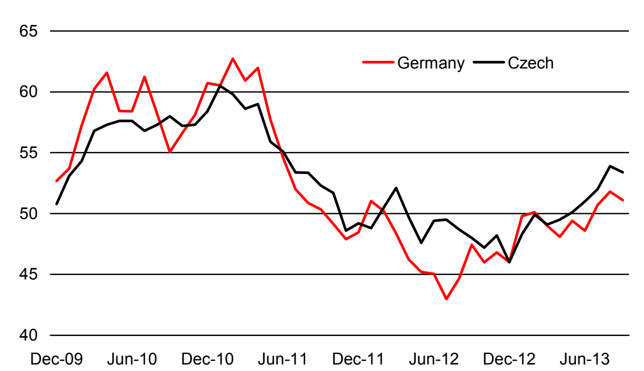
DOWNWARD INFLATION TREND NOT OVER



Source: CZSO, UniCredit Research

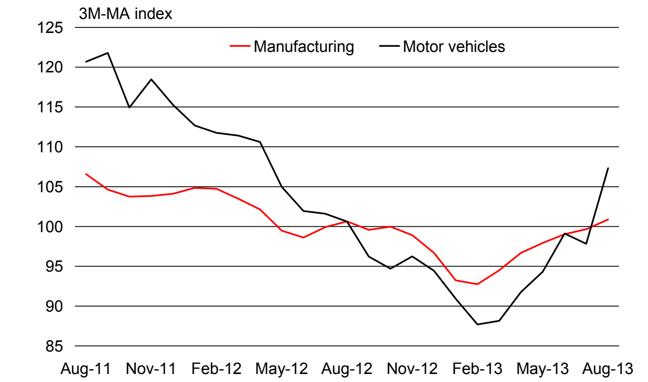
Czech Republic

MANUFACTURING PMI



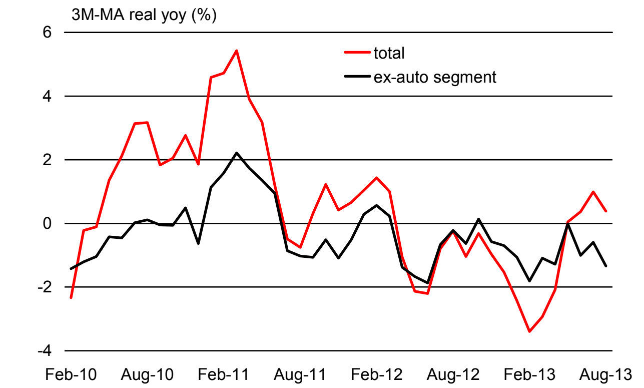
■ Czech PMI maintained its margin over German PMI following a similar retreat of both indices in September.

AUTOMOTIVE OUTPUT VS. MANUFACTURING



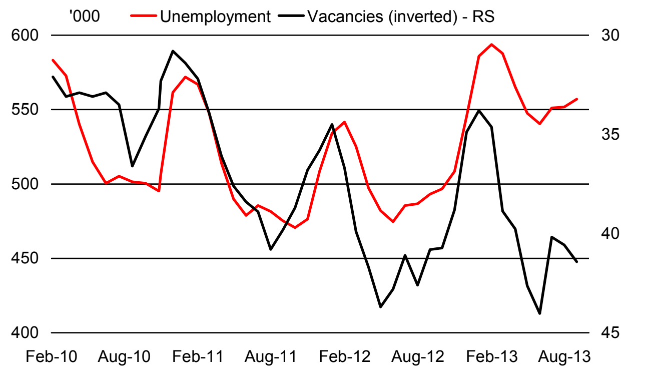
■ A surge in production of Skoda Auto helped restore the automotive sector's lead over manufacturing as a whole.

RETAIL SALES



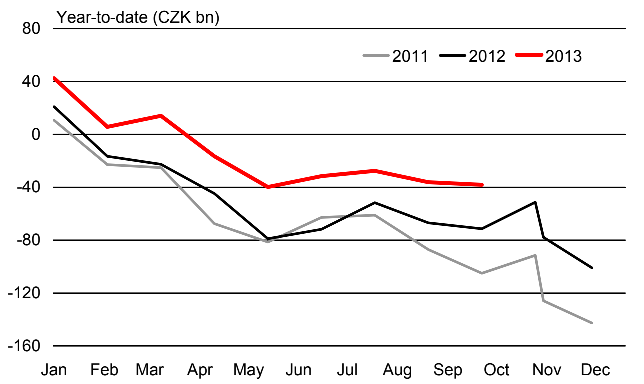
■ Total retail sales have shifted to growth territory, thanks only to the car segment. Core sales have continued to struggle.

UNEMPLOYED AND VACANCIES



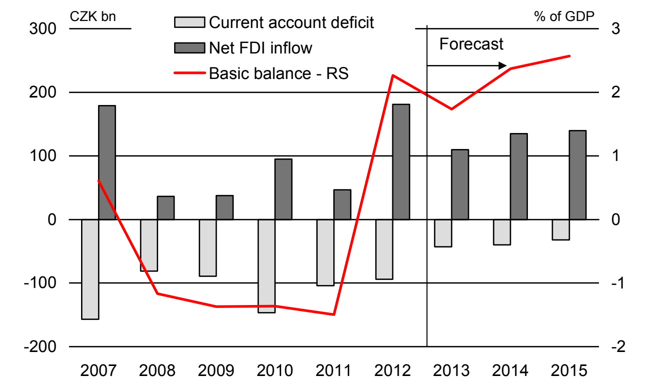
■ Unemployment has confirmed its status as a lagging indicator; vacancies as well showed little improvement from a year ago.

CENTRAL GOVERNMENT BUDGET BALANCE



■ The year-to-date development of the state budget deficit suggests that the full-2013 goal, at CZK -100bn, is unlikely to be exceeded.

CURRENT ACCOUNT AND FDI



■ Basic balance is heading for the second year of surplus. The outlook for the next few years also remains positive.

Source: CZSO, CNB, MinFin, UniCredit Research

Hungary

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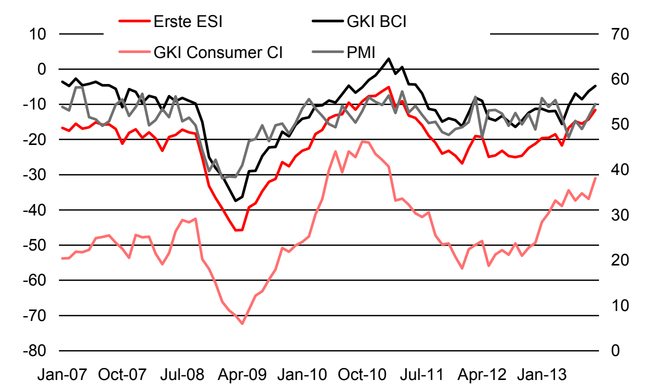
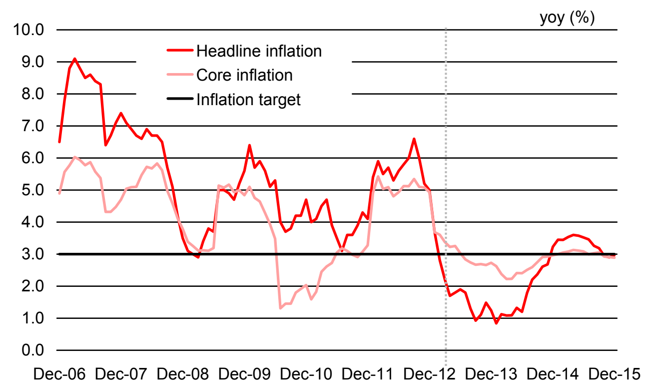
- 3Q13 data showed a gradual improvement in external demand, with industrial production rising 0.3% mom in July and 0.7% mom in August (SWDA). The slowdown of annual growth in August (to 0.9% yoy from 2.5% yoy in July) came after softer industrial production data in July for the euro area and especially for Germany. Merchandise exports rose 4.4% yoy in July 2013 after declining for two consecutive months and remain the most important GDP driver on the demand side. We maintain our forecasts for GDP growth at 0.7% in 2013 and below 2% in 2014 (+1.7%).
- Headline inflation slowed down to 1.3% in August and probably temporarily fell below 1% in September. After the energy and gas price cut in January 2013, the government plans another 11.1% cut to energy prices in 4Q14 and is considering VAT cuts for some foodstuffs in 2014. If all these cuts are implemented, we expect headline inflation to remain below 2% until 3Q14 and to rise towards the medium-term target of 3% by the end of next year, leaving scope for further rate cuts. Yet, core inflation remains stubbornly above 3%, showing the temporary nature of the current disinflation process.
- The National Bank of Hungary (NBH) cut the monetary policy rate to 3.60% on 24 September, and we expect it to cut it to 3.50% until the end of the year. Some of the external members of the Monetary Committee have expressed their concern about a too low base rate, but the risks remained skewed towards more aggressive cuts to 3%. A lower base rate helps the Hungarian government to contain its borrowing costs (by issuing mostly T-bills), reduces the cost of the Funding for Growth Scheme implemented by the NBH, and is reflected in lending rates. That said, the risk of a rapid reversal of rate cuts increases if the normalization of interest rates on international markets continues.
- While the negotiations on the conversion of FX mortgage loans to HUF are stalling, August marked the highest level of corporate new loans disbursed in HUF since May 2008. But, the reduction of outstanding FX loan volumes continues, offsetting the rise in HUF lending.
- The budget execution improved to a HUF 12.1bn surplus in September, but the 9M deficit stood at HUF 949bn, or almost 108% of the 2013 revised target. On 24 September, the Hungarian parliament increased the budget deficit to HUF 1,050bn, or 3.6% of expected GDP, but the ESA deficit figure is expected to fall below 3% of GDP due to a surplus for local administrations, the favorable budget treatment of the acquisition of E.On's gas business, and the use of budget reserves to cover part of the additional spending.

BROAD-BASED IMPROVEMENT IN SENTIMENT INDICATORS



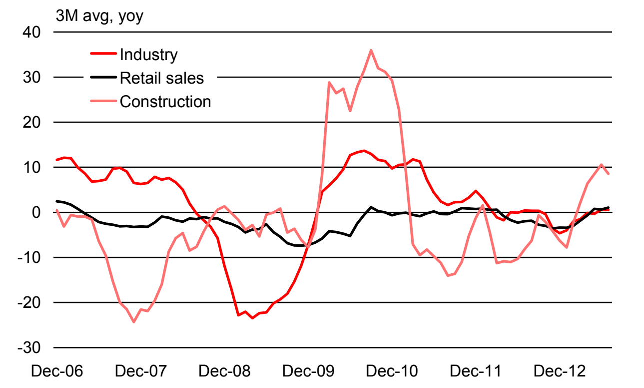
INFLATION TO REMAIN TAME UNTIL THE END OF 2014



Source: KSH, UniCredit Research forecasts

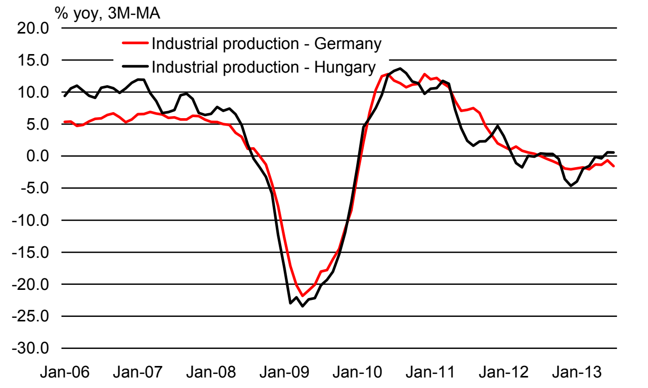
Hungary

INDUSTRY, RETAIL AND CONSTRUCTION



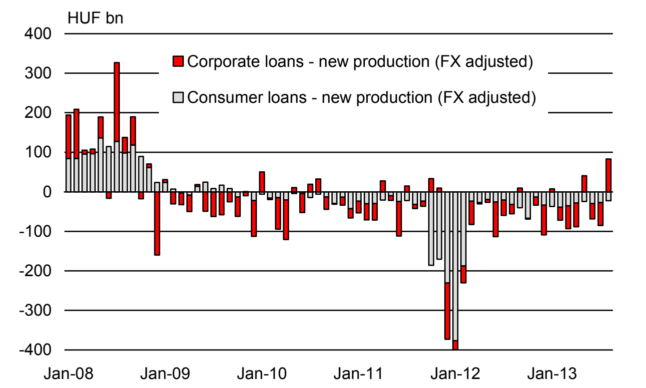
■ 3Q13 started with all three main economic branches growing…

INDUSTRIAL PRODUCTION



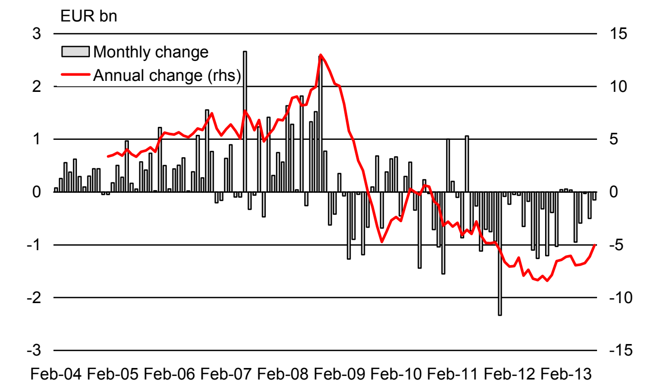
■ …and industry proving resilient to the German slowdown.

CORPORATE LOANS



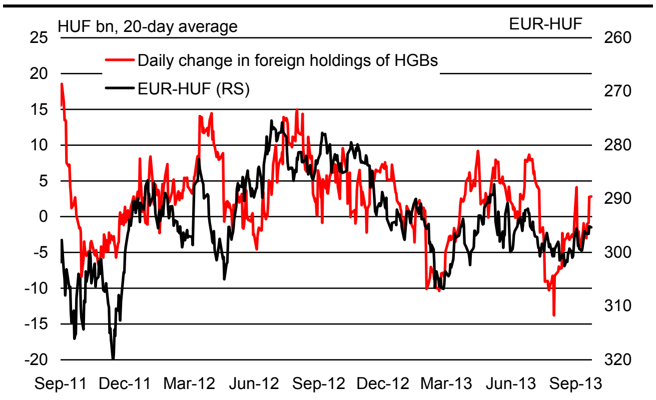
■ In August 2013, new corporate loans rose (FX-adjusted) by the largest amount since July 2008…

THE FOREIGN LIABILITIES OF THE BANKING SYSTEM



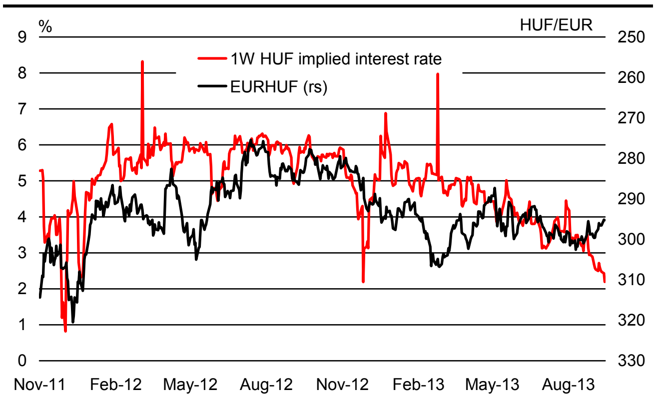
■ …while the deleveraging process in the banking system slowed down markedly in August.

HUF AND NET BOND PURCHASES BY FOREIGN INVESTORS



■ Renewed HGB buying supports the HUF…

LIQUIDITY CONDITIONS



■ … despite very loose liquidity conditions.

Source: KSH, NBH, AKK, Haver, UniCredit Research

US

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- Since the beginning of the month, the US government has been partially closed. The shutdown not only curbs government spending and weighs on business sentiment, but also causes delays in economic data releases. The assessment of the current situation and the near term outlook is, therefore, based on a very limited set of information.

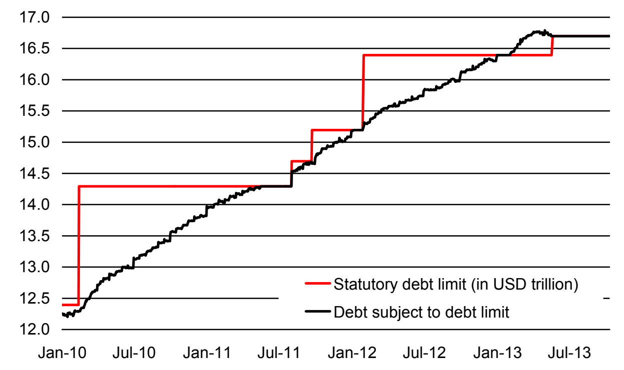
- The information that is available indicates that the US economy expanded somewhat slower than we had expected during the summer. We are, therefore, lowering our 3Q13 GDP growth estimate to 2.0% from 2.8%. In part, this can be seen as some payback following a stronger-than-expected 2.5% expansion in the spring. The downward revision reflects, in particular, consumer spending. In addition, shipments of capital goods are below the 2Q13 level, pointing to another quarter of sluggish investment spending.

- In addition, we will need to lower our 4Q13 GDP forecast, from 2.8% currently. Not only will the government shutdown subtract from growth, but the lasting uncertainty over the debt ceiling will weigh on domestic demand, notably business spending. Depending on the length of the shutdown, we will revise our forecast for the current quarter down to 1-2%.

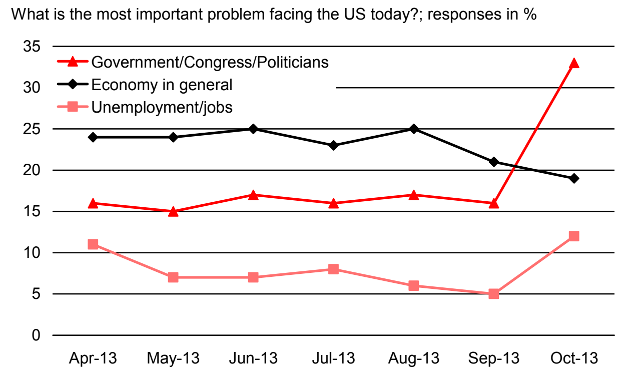
- With regard to the debt ceiling negotiations, we continue to assume that the political parties will eventually be able to find some face-saving agreement in time to avoid a default. The deal might include some shifts in the sequester spending cuts from defense to entitlements, and the repeal of the medical device tax.

- At its mid-September FOMC meeting, the Federal Reserve surprised financial markets by not slowing the pace of its asset purchases. The main reasons for the decision were tighter financial conditions, a lack of improvement in the economy, and concerns about potential fiscal headwinds. These reasons have been unequivocally vindicated by the latest events. In a scenario in which the debt ceiling will be raised for a reasonable period in late November/early December, we expect tapering to begin at the late-January meeting. If, however, the negative implications on the economy and financial markets from the budget battle are too severe, tapering might even be delayed until mid-March.

DEBT CEILING NEEDS TO BE INCREASED



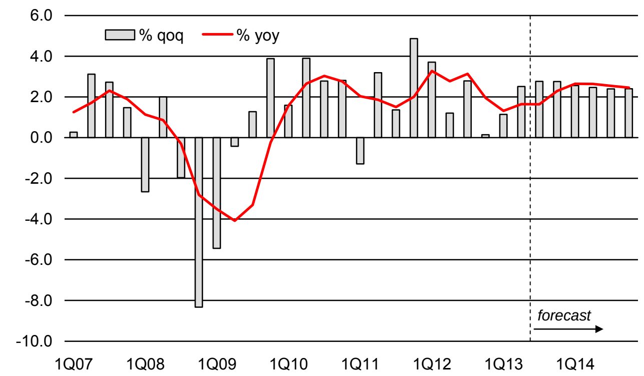
DYSFUNCTIONAL GOVERNMENT THE BIGGEST PROBLEM



Source: Treasury Department, Gallup, UniCredit Research

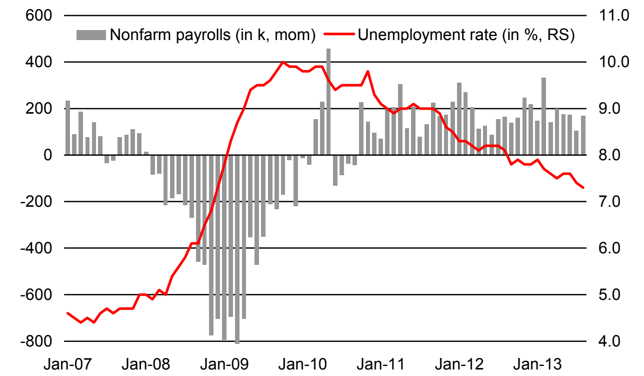
US

REAL GDP, ANNUALIZED RATES OF CHANGE



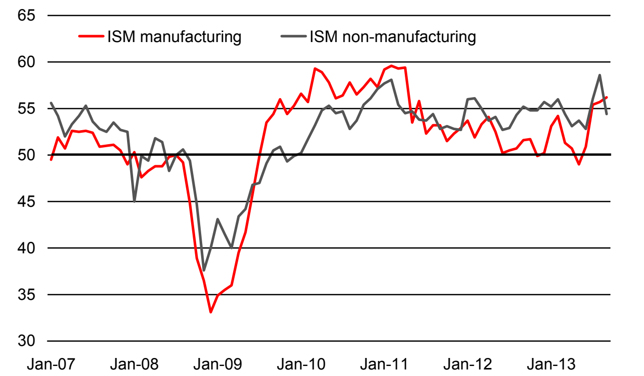
- Following a solid 2.5% in 2Q13, economic growth likely slowed to 2% in 3Q13. Fiscal policy will be a drag in the current quarter.

NONFARM PAYROLLS AND UNEMPLOYMENT RATE



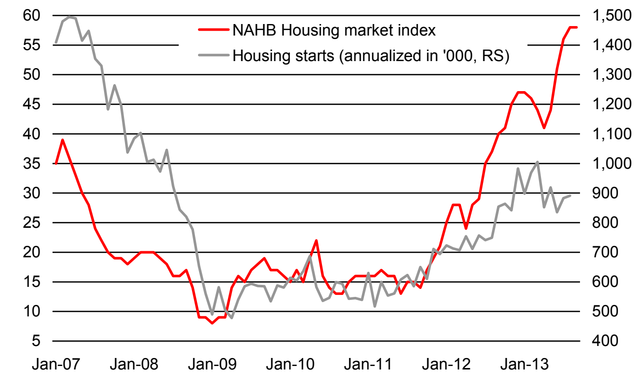
- The shutdown delayed the release of the September employment report. In August payrolls increased by 169,000.

PMIS



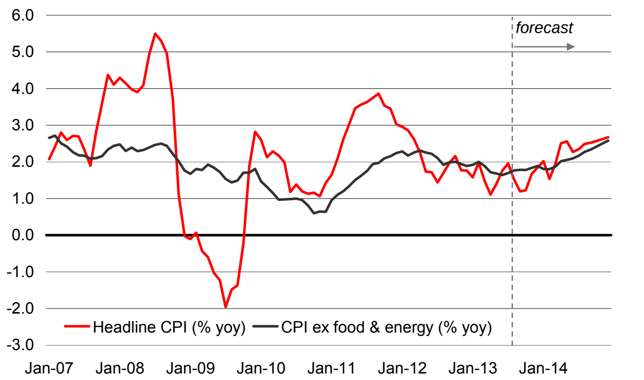
- The manufacturing ISM rose to a 2½Y high of 56.2 in September, while the non-manufacturing index fell to 54.4.

HOUSING MARKET INDEX AND HOUSING STARTS



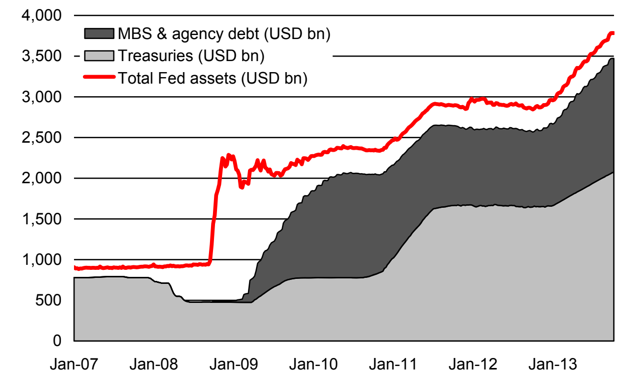
- The NAHB index stayed at an 8Y high of 59 in September, signaling further increases in construction activity.

INFLATION



- The headline inflation rate eased to 1.5% yoy in August, while the core rate edged up to 1.8% yoy.

FED'S BALANCE SHEET



- The size of the Fed's balance sheet rose to USD 3¾ trillion, as the FOMC continues its large-scale asset purchase program.

Source: BEA, BLS, Federal Reserve, Institute for Supply Management, NAHB, Census Bureau, UniCredit Research

Switzerland

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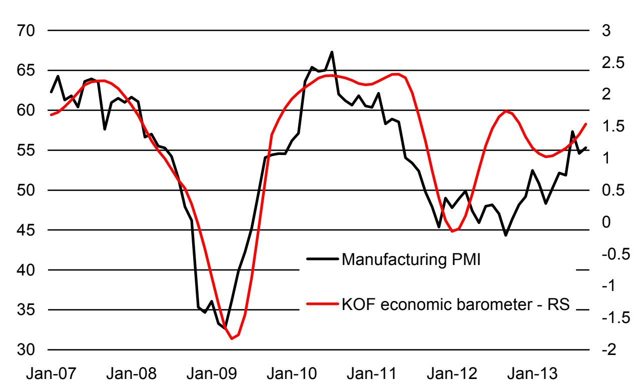
- Swiss leading indicators continued to point north. The KOF rose at the fastest pace mom in September during the last 12 months (see left chart). The Manufacturing PMI also rose slightly. Its level of about 55 points to substantial expansion in the industrial sector in the coming months.

- In general, the upcoming recovery in Europe bodes well for future Swiss export activity and the overall economy. Although export expectations of Swiss companies have already been at elevated levels for quite some time (see right chart), we see room for further improvement. After all, the Swiss export share to EU countries is 56% (Germany: 20%). We stick to our GDP growth forecast of 1.8% for 2013 and 2014, with more upside than downside risks.

- At its quarterly meeting in September, the Swiss National Bank (SNB) kept the minimum exchange rate of CHF 1.20 per euro unchanged. The target range for the 3-month Libor also remains at 0.00-0.25%. The central bank reiterated that it stands ready to enforce the minimum exchange rate, if necessary, by buying foreign currency in unlimited quantities, and to take further measures, as required. In a speech in October, SNB chairman Jordan defended the exchange rate policy, saying that Switzerland's current account surplus is not caused by the exchange rate but by structural factors. In our view, the SNB will maintain its cautious rhetoric and keep its wait-and-see stance in the foreseeable future.

- The SNB now sees some signs of easing in the housing market, as reflected in a modest slowdown in price and mortgage dynamics. But growth in mortgage lending remained strong and the SNB will continue to monitor the situation closely. Accordingly, we still see the possibility that the SNB will suggest a raise in the countercyclical buffer (CCB) from the current level of 1% of risk-weighted mortgage loans later this year to increase resilience in the domestic financial sector.

BUSINESS SENTIMENT LEVELS CONTINUED TO INCREASE

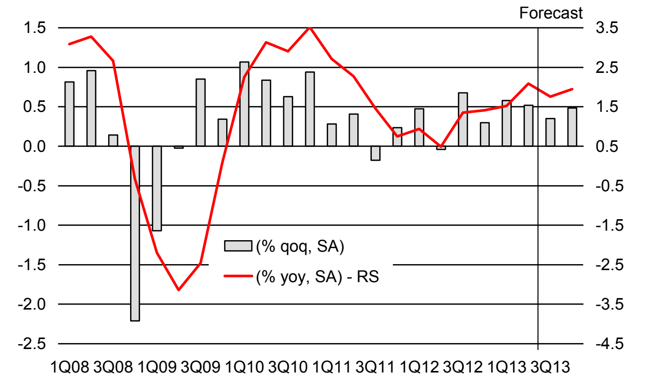


FURTHER UPWARD POTENTIAL FOR SWISS EXPORTS

Source: KOF, Thomson Datastream, SNB, UniCredit Research

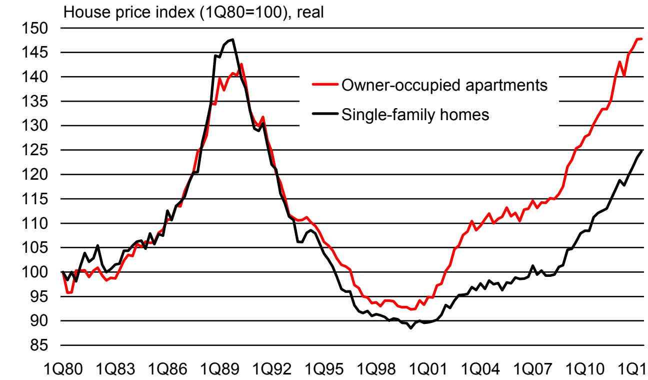
Switzerland

GDP



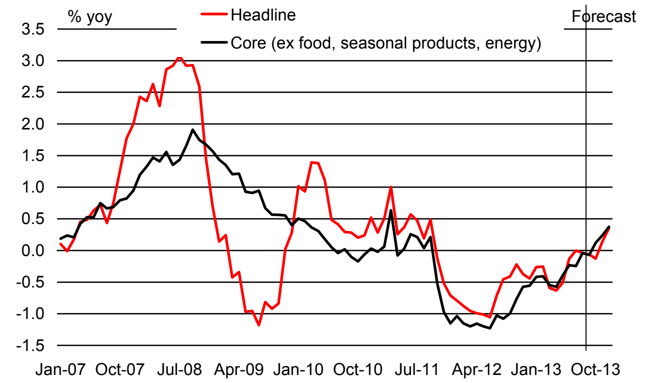
- We expect the Swiss economy to expand further after a solid 0.5% in 2Q13.

HOUSE PRICES



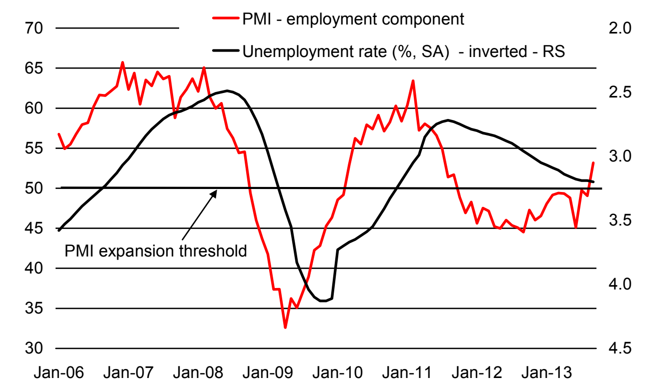
- House price dynamics for owner-occupied apartments have slowed somewhat recently.

INFLATION



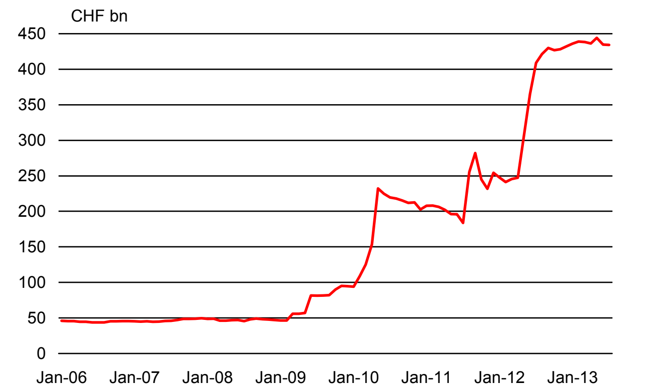
- Consumer prices were down 0.1% yoy in September. We expect the headline rate to slightly increase in the next few months.

LABOR MARKET



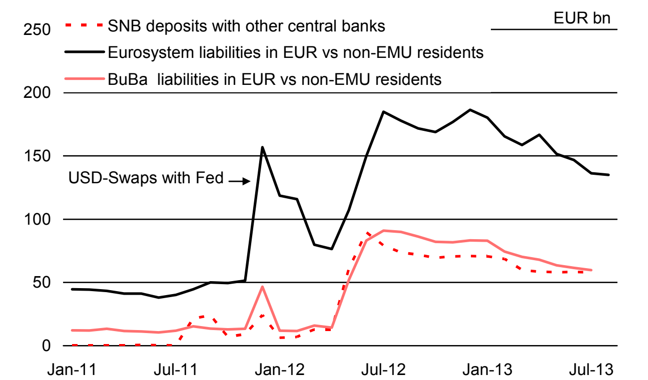
- The PMI employment subcomponent improved substantially, pointing to lower unemployment in the medium term.

FX RESERVES



- The SNB's FX reserves on a CHF basis basically trend sideways since autumn last year.

FX CURRENCY MANAGEMENT



- A substantial share of the EUR reserves purchased in 2012 is still parked at central banks and is being invested only gradually.

Source: SECO, KOF, Thomson Datastream, Bloomberg, SNB, UniCredit Research

Russia

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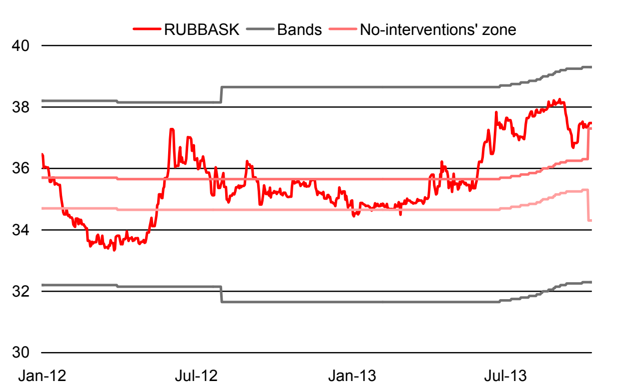
- The CBR has been the major newsmaker during the last month. On 8 October, the regulator disclosed the details of its exchange rate policy execution mechanism. In particular, the regulator widened the center bi-currency band in which it does not intervene to RUB 3 from RUB 1, abandoning small-scale (USD 70mn) currency operations that used to be implemented to smooth exchange rate deviations within +/-RUB1 from the mid-range. If the value of the bi-currency basket deviates further from the center of the range, the CBR is ready to purchase or sell up to USD 200mn on a daily basis, and if the value of the gauge moves to within RUB 0.95 from the boundaries, the size of daily interventions is increased to USD 400mn. The recent action represents another big step towards greater ruble flexibility, and complies with the CBR's goal to accomplish a freely floating exchange rate regime by the end of next year. However, it also implies diminishing CBR support to the domestic currency, which may add to the usual seasonal pressure in 4Q. In addition, the likelihood of an interest rate cut by the CBR decreases substantially in the medium term as the regulator must take RUB depreciation into account to project the inflation trajectory.

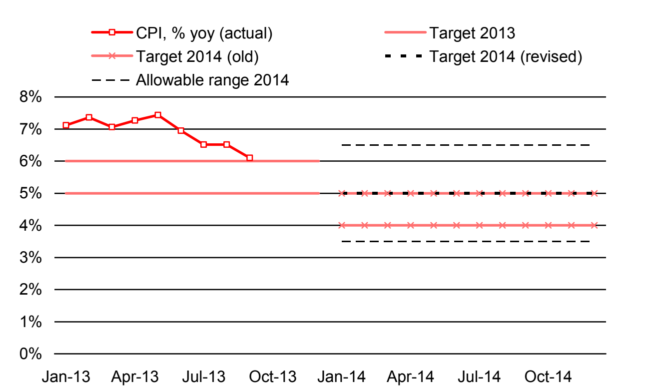
- At its September meeting, the CBR introduced a number of changes to its interest rate framework. The minimum weekly auction repo rate (currently at 5.5%) was defined as the key policy benchmark, while the refinancing rate will be used for fiscal purposes only until it converges to the level of the key rate by the end of 2015. At the policy meeting of 14 October, the regulator maintained the key rate unchanged, but refrained from providing any guidance on its acceptability in the medium term in the accompanying statement. This leaves room for a potential interest rate change in the future, especially as the regulator pointed out an improvement in inflation trend. However, the CBR governor maintains her view that structural problems underlie the economic slowdown, and the CBR was quite hawkish in budget discussions with the government. In any case, we believe that a cut in the key rate by more than 25bp before the year-end is highly unlikely.

- The Russian government approved an increase in utility tariffs for the population in 2014 instead of a complete freeze for all types of consumers, prompting the CBR to raise its inflation target for 2014 to 5.0% (up from 4.5%). Regulated prices contribute up to 25% to the headline inflation figure, while remaining beyond the CBR's direct control. In general, the revised inflation target, in our view, is more achievable than the previous one, although the credibility of inflationary targeting may be somewhat compromised as a result. It is also worth mentioning that, although the CBR has adopted a point estimate as a target for 2014 (rather than a range of values), it has also set the allowable deviation from it at +/-1.5 pp. The resulting band is effectively wider than it used to be (3.5-6.5% instead of 4-5%).

RUBLE REMAINS UNDER PRESSURE



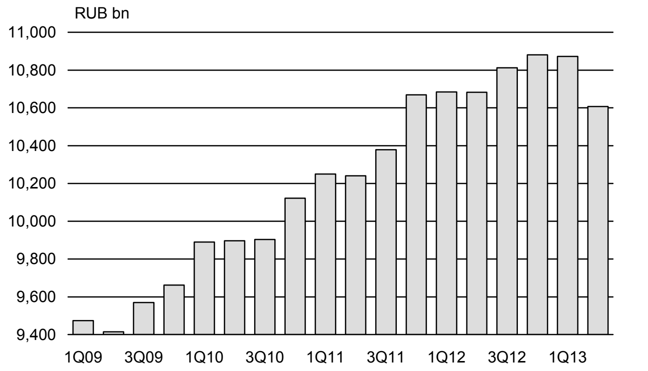
CBR INFLATION TARGET REVISED



Source: CBR, Rosstat, UniCredit Research

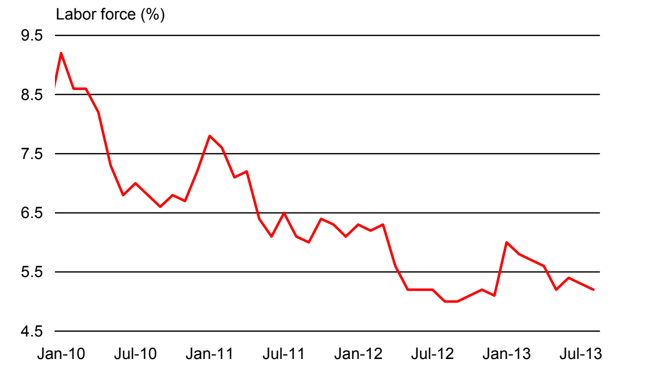
Russia

GDP (SEASONALLY-ADJUSTED QUARTERLY DATA)



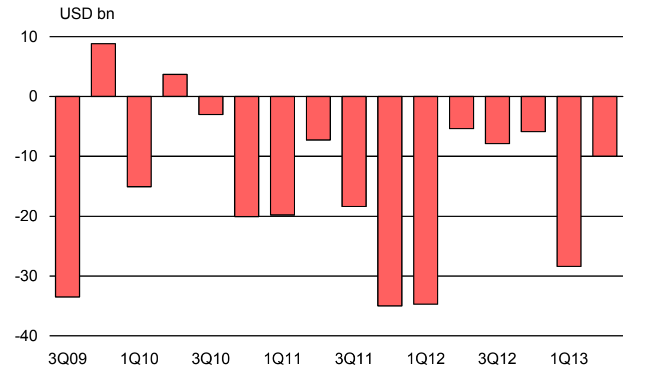
- GDP rose only 1.4% yoy in 1H13.

UNEMPLOYMENT RATE



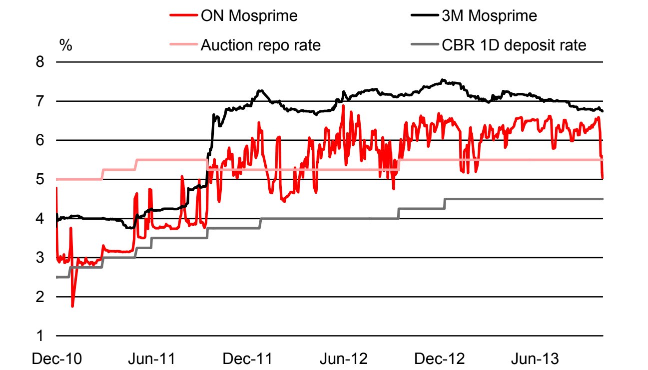
- However, unemployment rate remains close to all-time lows.

CAPITAL OUTFLOW



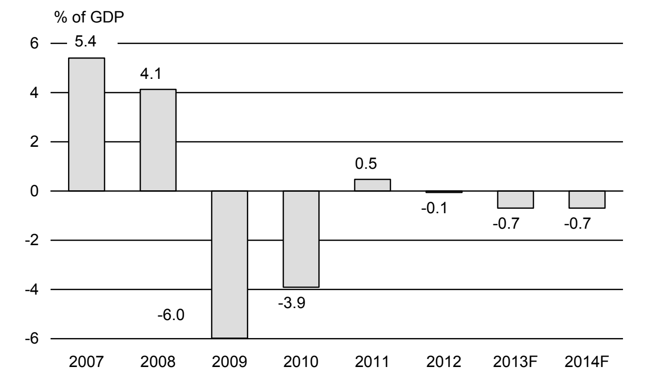
- Financial account likely deteriorated in 3Q13: net capital outflow slowed in Sept, but is estimated at USD 16-17bn in July – Aug.

MONEY-MARKET RATES



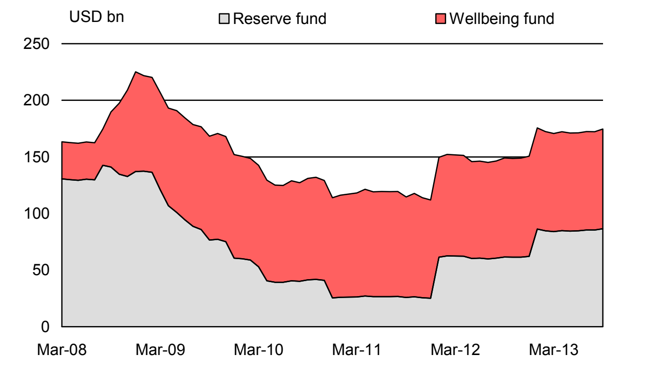
- Overnight rates dropped below 5.5% in early October, although no visible improvement in ruble liquidity was registered.

BUDGET BALANCE



- Achievement of fiscal targets is likely to call for a downward revision of expenditures, or an improvement in revenues (e.g. by means of a weaker ruble).

STATE FUNDS ACCUMULATION



- Government may fail to top up Reserve Fund in 2013, having to honor current obligations.

Source: Ministry of Finance, Bloomberg, CBR, Rosstat, UniCredit Research

Turkey

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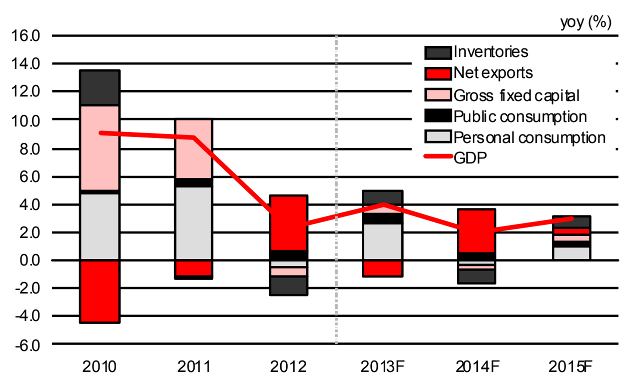
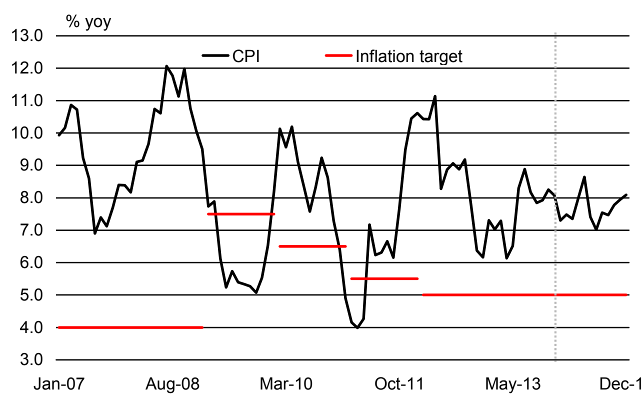
- The Turkish authorities are facing an unenviable task. The past month has generated a series of steps from the government aimed at alleviating political pressures, while we have some further evidence that at least the initial stages of a much-needed adjustment in domestic demand are materializing. On the political front, PM Erdogan announced a democratization package last September. Measures included: **1.** the withdrawal of the ban on headscarves in public institutions; **2.** facilitation of use of other languages; **3.** inclusion of private education and political party advertising; and **4.** extension of financial aid to political parties, among others. All in all, the measures were not surprising, designed as a step in that direction which tempers the concerns of the "masses" and signals a more constructive stance from Erdogan post-Gezi.
- Meanwhile, some of the measures taken by the authorities risk proving counter-productive. That the government continues to draw off fiscal policy to support activity is not surprising. 2Q GDP data showed government consumption and investment up 7.4% and 36.7% yoy, respectively. Monthly budget data to August show current expenditure less interest in real terms up 12.2% YTD. The CBT's decision to reduce FX interventions and allow the TRY to depreciate is welcome but interventions remain non-negligible. From the USD 5.2bn done in July, FX interventions over the past 20 working days stood at USD 1.7bn (ca. 5% of reserves). Concerningly, these interventions are being accompanied by increased TRY liquidity provision to the banking sector via OMOs (ca. 2% of GDP). On the one hand, this helps government funding but also risks keeping credit growth higher for longer. Moreover, while interest rate hikes are not considered an option at this stage, a persistent negative real interest rate risks deterring foreign capital.
- There has been some macro adjustment YTD but there is much more to be done. Weekly data for the week ended 4 October slowed to 29.9% (13-week average annualized), down from 37.6% seven weeks ago. Meanwhile, holdings of domestic debt saw outflows of USD 0.27bn, though still up USD 6.3bn YTD. Yet this represents half of the debt inflow seen during the same period of last year (USD 13.1bn). All of the above represents a necessary adjustment in Turkey. The strong improvement in the C/A deficit seen last August (to USD 1.9bn from USD 5.9bn in July) is certainly welcomed but, with credit growth still doubling, the CBT's target, further adjustment ahead will be required. But, as per this week's Medium Term Program, the authorities believe that any narrowing of the C/A deficit will be limited. For this to materialize, foreign capital flows must gather pace significantly from here. Otherwise, further TRY and growth adjustment will prove unavoidable.

DOMESTIC DEMAND IS EXPECTED TO LEAD THE RECOVERY



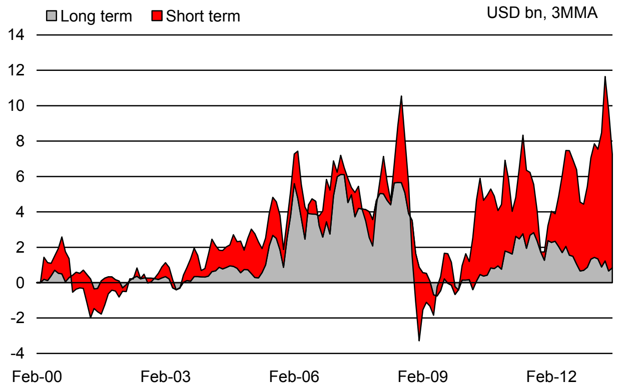
INFLATION TO EASE BUT REMAINS ABOVE TARGET



Source: CBT, TurkStat, UniCredit Research

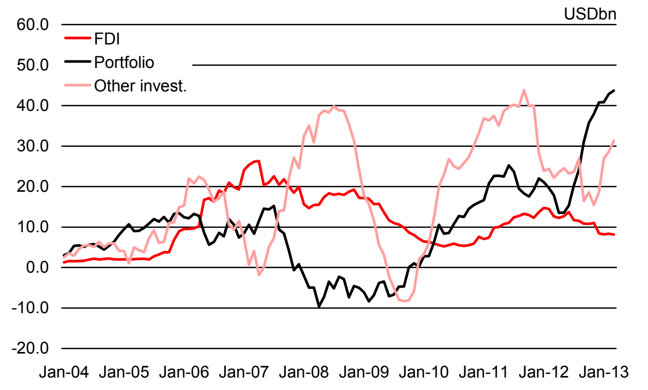
Turkey

FOREIGN CAPITAL FLOWS INTO TURKEY



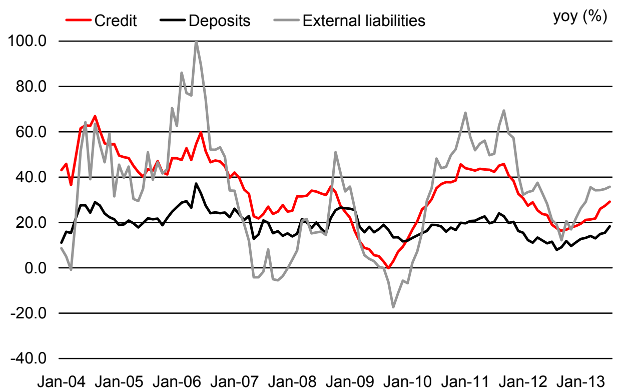
■ There has been a shift from long-term to short-term capital flows.

C/A FINANCING



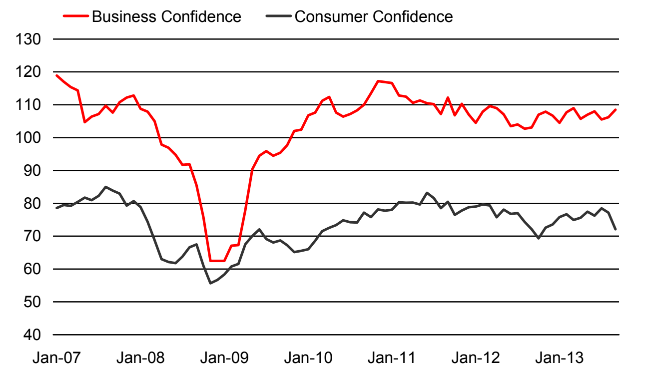
■ C/A funding remains too dependent on portfolio inflows.

CREDIT VS. DEPOSIT GROWTH



■ Funding will constrain credit growth going forward.

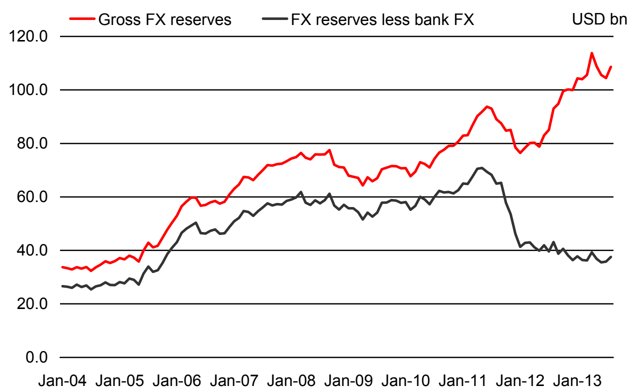
CONSUMER AND BUSINESS CONFIDENCE



Index = 100 represents a stable economic outlook; Index > 100 (<100) represents an optimistic (pesimistic) outlook.

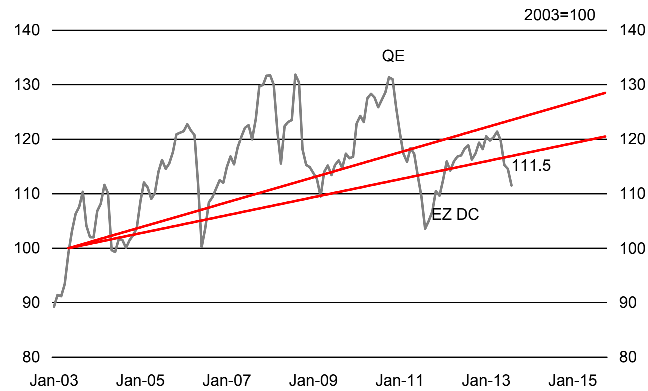
■ Business and consumer confidence levels remain stable.

GROSS VS. NET FX RESERVES



■ The CBT has limited ammunition for outright interventions…

TURKEY'S REAL EFFECTIVE EXCHANGE RATE TARGET



■ …limiting its ability to maintain the REER under control.

Source: CBT, TURKSTAT, UniCredit Research

China

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- Economic data published over recent weeks came in on a stronger (than expected) note, indicating that economic growth in China over the summer months has recovered moderately versus the spring quarter. We therefore expect 3Q13 real GDP to have advanced 7¾% yoy following the slowdown we have seen in 1H13 (2Q13: +7.5%).

- The reasons for the slight firming of Chinese economic activity are twofold. First, and most important, the policy shift in late July seems to be already bearing some fruit. Authorities were no longer willing to tolerate the growth slowdown, but wanted to stimulate growth with a (limited, but targeted) package. Investment spending was stepped-up immediately, while tax & financial incentives should lend a helping hand to exporters as well as services SMEs.

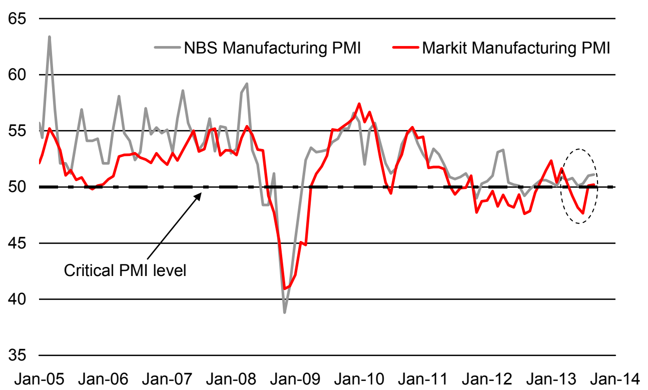
- Secondly, external demand is improving, as indicated by the upward trend in global PMIs as well as rising new export orders for China. Although the prior CNY appreciation and rising input costs are still exerting some downward pressure on export dynamics, the country's exports should trend higher and, thus, fuel production.

- Support is also coming from increased investment spending, first and foremost of infrastructure outlays. And manufacturing investment started to stabilize as well. In contrast, housing (in-vestment) continued to lose traction due to ongoing restrictive measures to contain brisk house price inflation that more recently reached its highest reading since autumn 2011. Finally, the second pillar of domestic demand, private consumption, firmed as well over the summer months, with growth rising to the highest rate so far this year in August.

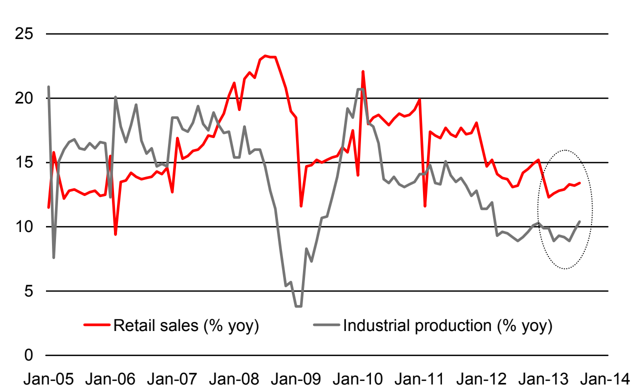
- But looking ahead, we doubt that the recent policy shift will have a lasting effect, ending in a notable and sustained upward trend in economic growth. While recent measures should also give some support to the current quarter and next (with GDP probably growing by a higher 7½% rather than the 7¼% yoy we have been expecting so far), the medium-term trend still seems to be heading south, caused by both cyclical and structural reasons.

- The authorities' firm stance to keep credit expansion at the targeted level (implying less growth in 2H13 after the spurt in the first half of the year) and to prevent a (high-end) housing bubble as well as ongoing rebalancing efforts (dampening overall growth) and declining potential growth should show up in GDP expansion rates heading toward 7% late next year rather than approaching the 8% mark.

BUSINESS SENTIMENT BACK IN EXPANSIONARY TERRITORY AGAIN…



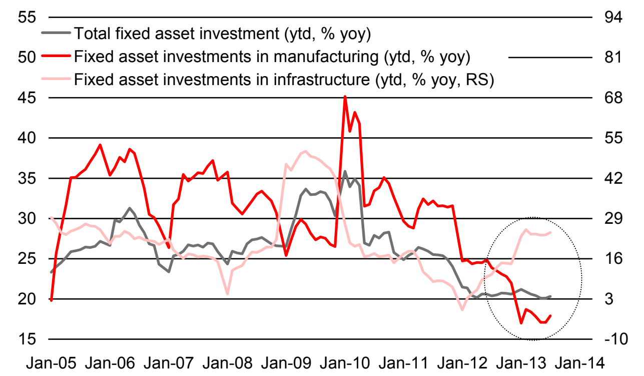
…WITH ACTIVITY FIRMING GRADUALLY



Source: Thomson Datastream, Feri, UniCredit Research

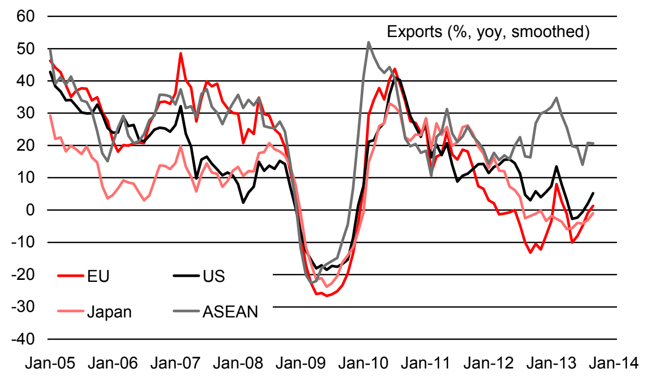
China

FIXED ASSET INVESTMENT



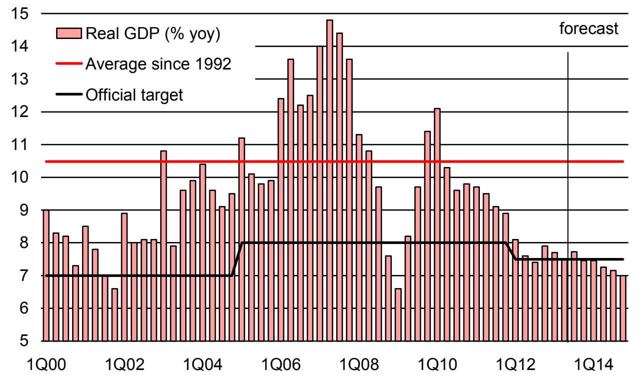
- Investment will continue to profit from infrastructure spending which was stepped-up again. But recently, capex growth seems to have stabilized as well.

EXTERNAL ECONOMY



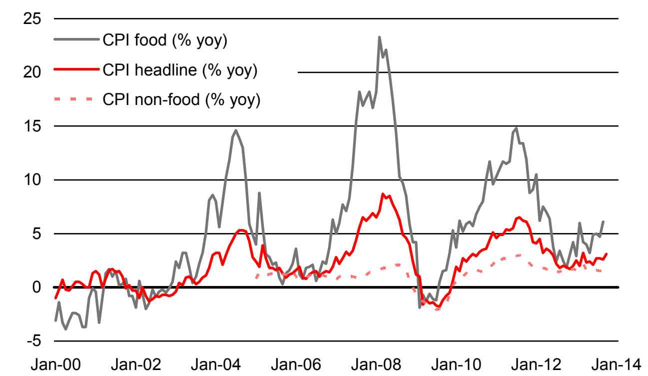
- Following accentuated ups and downs, caused by incorrect accounting and government intervention, export growth should strengthen again on the heels of improving global demand.

GDP



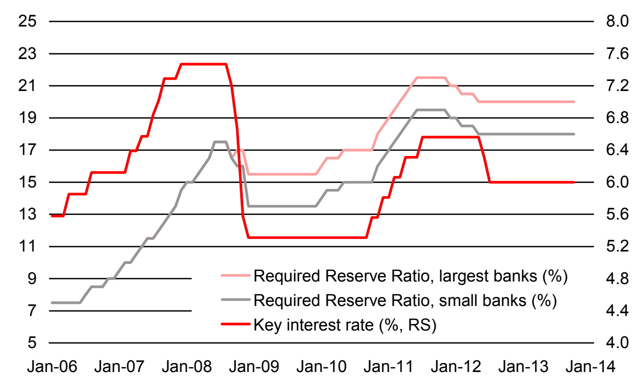
- Improving sentiment and activity data indicate an improved 3Q13 GDP reading and also lend a helping hand this quarter and next. But the medium-to-longer term trend is tilted to the downside.

INFLATION



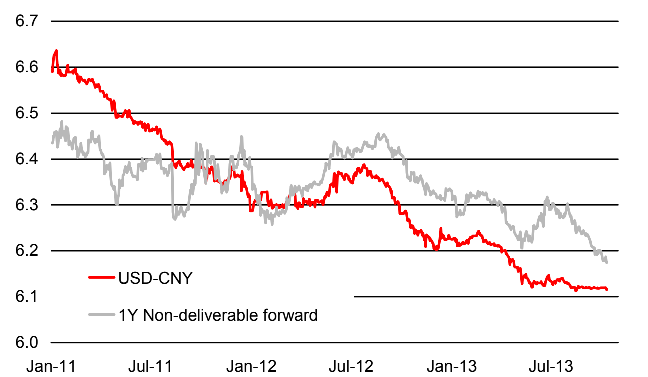
- Following the January 2013 uptick, inflation is fluctuating well below target (3.5%) – helped by lower input prices...

MONETARY POLICY



- ...so the PBoC has room to maneuver. But its stance became tougher in the spring, as it is unwilling to accept excessive credit growth.

USD-CNY

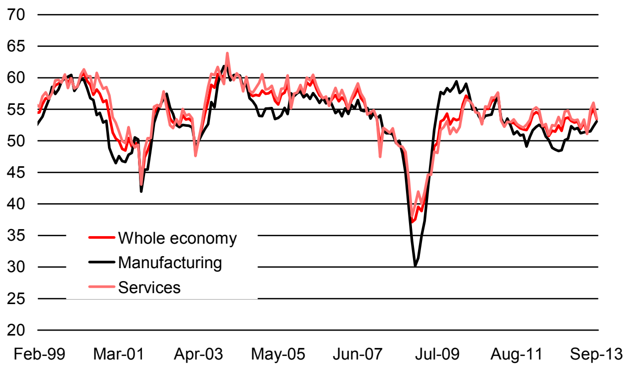


- After having appreciated earlier this year, the CNY moved into quieter waters recently.

Source: Thomson Datastream, Feri, UniCredit Research

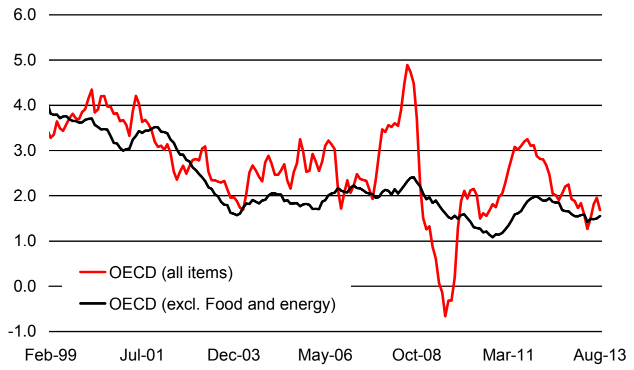
Global Indicators

GLOBAL PMI OUTPUT



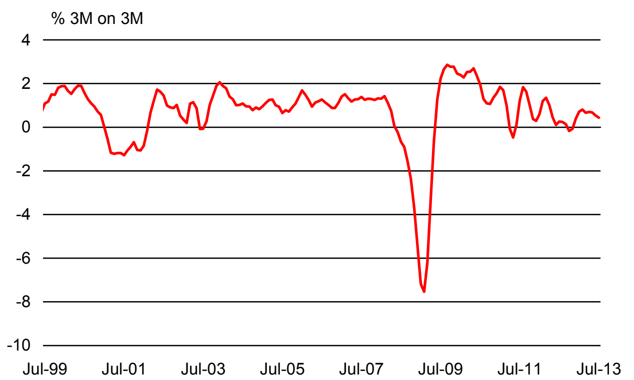
- The global composite PMI fell from 55.1 to 53.5 in September. The manufacturing output index rose from 52.3 to 53.1, while the services index fell from 56 to 53.6.

CPI INFLATION



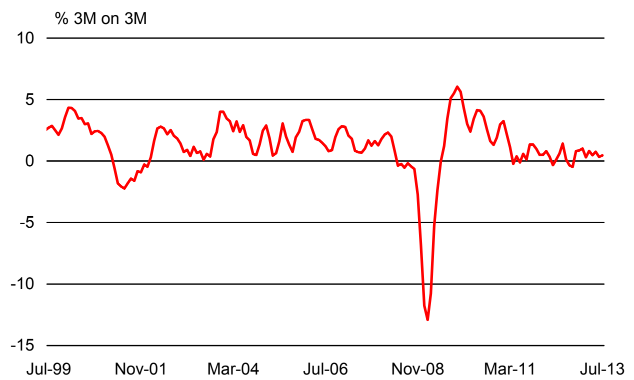
- Headline inflation in OECD economies slowed from 2.0% yoy to 1.7% yoy in August, with the core rate up from 1.5% yoy to 1.6%.

INDUSTRIAL PRODUCTION



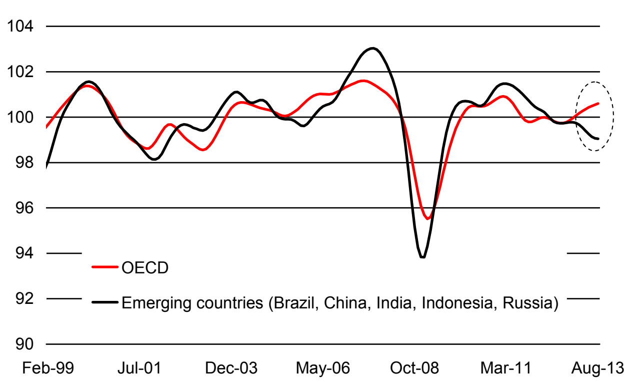
- Global IP was up 0.5% mom in July (vs. 0.0% in June). The 3M/3M rate edged down slightly from 0.5% to 0.4%.

WORLD TRADE



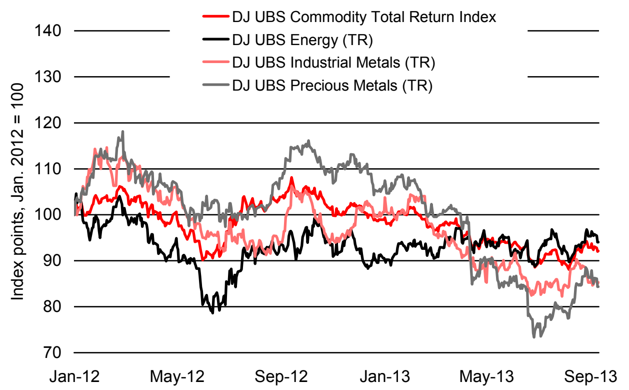
- World trade increased 2.2% mom in July after 0.5% mom decline in June. The 3M/3M rate increased from 0.3% to 0.5%.

OECD COMPOSITE LEADING INDICATORS



- The OECD leading indicator for OECD countries (aggregated) edged up further in August, while the indicator for the emerging economies (aggregated) fell slightly.

COMMODITIES



- We expect the price of Brent crude to move sideways over the next two years, due to strong supply from North America (shale oil) and Iraq. The gold price will likely remain under pressure.

Source: Bloomberg, CPB Netherlands, OECD, UniCredit Research

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